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THE BUREAU OF BUSINESS RESEARCH

COLLEGE OF COMMERCE AND ADMINISTRATION

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THURSDAY, MAY 15, 1958—10:00 A.M.
The Ohio Union—West Ballroom

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ALVIN R. JENNINGS, *President, American Institute of Certified Public Accountants; Partner, Lybrand, Ross Bros. & Montgomery, New York*

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ACCOUNTING RESEARCH

By Alvin R. Jennings
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There is, I think, widespread acceptance of the proposition that accounting is utilitarian in character. In this sense, it is like the law. Both must be kept responsive to the needs of changing times and both disciplines must be susceptible of making the accommodations required to keep in harmony with significant social and economic goals. It follows that the body of principles which is created to implement accounting must be widely understood and accepted as valid or the end product will be of limited value. It follows, too, that it is not enough for a principle to achieve acceptance—it must continue to merit acceptance or yield to another more compatible with the needs.

During the past few years, with increasing frequency, well-informed people, both within and without the profession, have questioned whether accounting has in fact kept abreast of the times. The late Marquis G. Eaton in an address delivered last Spring discussed "Financial Reporting In A Changing Society." His paper identified important and pressing problems. Oswald W. Knauth, business executive and economist in his article which appeared in the January 1957 *Journal of Accountancy* has given us a stimulating external point of view of limitations on the usefulness of financial reports growing out of lack of comparability. George O. May whose career has spanned more than 60 years of professional developments and who through most of that period was closely associated with the progress of accounting thinking, on numerous occasions has stressed the critical need for recognition that accounting philosophies suffer from obsolescence. Among the significant social and economic changes which Mr. May believes require reorientation in existing modes of accounting thinking are:

(1) the adoption of the full employment theory which was enacted into law in 1946;
(2) the great acceleration in the rate of change in the industrial economy since 1940; and
(3) the social revolution which has occurred since 1940 and which is rooted in the adoption of a political philosophy dedicated to the lessening of inequalities of wealth and income.

There is, I think, much merit in this point of view.

Clearly, the time is at hand for critical reappraisal of the continued validity of the basic objectives of accounting and the methods upon which we rely to identify the correlative, postulates, assumptions or conventions which may best serve our purposes.

One of the techniques in which we, as accountants, have been carefully trained is that of analysis. We use it liberally as a method of searching for sound conclusions. This morning I am going to ask you to join me in some self-analysis of an introspective nature. My specific interest today is in accounting principles. What is their nature? What purpose do they serve? How do they come into being? Are they immutable? If not, how do useful changes come about? These are some of the questions which I would like to consider with you and, since we have not much time, we cannot go into any of them deeply enough to reach supportable and valid conclusions. That does not bother me, and I hope it does not bother you. It is unrealistic to expect that all thinking should result in decisions. The most I think we can hope for is that it will make a contribution to that end. Often an understanding of why we cannot presently reach conclusions is the key to further progress.

Accounting—Art or Science? Principles give meaning to accounting. To better understand why, let us spend a minute or two thinking about accounting as such. It has been described by some as an art—by others as a science. The question of classification of itself has limited meaning. Of more interest are certain apparent distinctions between the characteristics of accounting, whether art or science, and those of certain branches of science such as the physical sciences.

The physical sciences are concerned with the study, observation and classification of phenomena. Their interest is in learning the natural characteristics of things and how and why they are as they are and most particularly in the establishment of verifiable general laws or principles. In lay language they work backward from the result to the principle or combination of principles which brought about the consequences. Once identified and defined, the principles are immutable and the only thing which brings about change is the discovery of error in the original analysis. The inductive thinking and the hypotheses of the scientist involve the frequent use of standards of one sort or another and many of these have been arbitrarily established. Standards of measurement are examples. The units of measurement of time and space, as we know them, are purely arbitrary tools of convenience. Changes occur from time to time as more useful standards are discovered. The cubit was widely accepted in biblical times as one unit of length; today it is obsolete. It is possible, though not ideal, that two or more systems of measurement may exist and be in use simultaneously in different parts of the world. The metric system which many regard as superior to the system commonly in use in this country will, in all probability, some day be in common use here. These differences, while introducing a certain awkwardness where comparisons or combinations of data are concerned, have no greater significance than differences in the currency systems of the world because they are more or less readily translated one into the other.

Accounting, which is a discipline of expression, like the physical sciences, works with facts but this is the sole significant point of community. Where science looks within the fact to discover principle, accounting looks, or should look, to the desired end result—the most effective method of expression in terms of that which will meet the greatest needs—and proceeds to create and define those principles which will achieve its ends. Thus, as I have said, principles give meaning to accounting and accounting will fall far short of its proper function if it is, or should become, shackled to principles unsuitable to its needs.

Principles and Methods: In auditing we have drawn a sharp distinction between standards, which Professor Mautz will discuss later this morning, and procedures. Attempts have been made to develop a similar, logical distinction in accounting—that is, between principles and methods of applying principles. At first blush, it might appear important that we should promote an awareness in accounting between principle and method, but I wonder if this is so. The distinction in the field of auditing is important to us as auditors because of what it contributes to our ability to make our examinations of reasonably consistent quality.

In the field of accounting, if the distinction between principle and method has significance, it can only be for what it may contribute to the ability to turn out more useful statements which, of course, implies that those who make use of the statements must have the same full understanding of the distinctions as does the accountant who is responsible for the preparation or approval of the data. We know this is not so today and I, for one, despair that it will ever be so. This is no mere academic defect. It is, in fact, very close to the root of some of the criticism which has been voiced with increasing frequency in the last decade concerning financial representations. I do not advocate that we should abandon the concept of usefulness in distinguishing between principle and method. I do hold that there is no logical or practical merit in seeking to narrow the choices of acceptable principles and, at the same time, allowing such wide latitude of choices of method as to make the principle itself relatively of no importance.

The distinction between an accounting principle and an accounting method or practice is one which has also caused the SEC some concern. Because no clear distinction exists between accounting principles, on the one hand, and accounting practices and methods, on the other hand, the SEC promulgated Rule 3.07 in its Regulation S-X reading as follows:

(a) Any change in accounting principle or practice, or in the method of applying any accounting principle or practice, made during any period for which financial statements are filed which affects comparability of such financial statements with those of prior or future periods, and the effect thereof upon the net income for each period for which financial statements are filed, shall be disclosed in a note to the appropriate financial statement.

In addition, Rule 2.02 of the same regulation dealing with accountants' certificates provides, among other things, that the accountants' certificate shall state clearly:

(ii) the opinion of the accountants as to any material changes in accounting principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, require to be set forth by Rule 3.07.

Emergence of Principles as Criteria: Except in regulated industries, until some 25 years ago, there were virtually no effective restrictions on the choices of management as to the principles of accounting and disclosure which they used in setting forth financial representations. The advent of the tax on corporate income in 1913 brought about some measure of uniformity as corporate accounting veered toward the acceptance of those practices which would tend to minimize taxes. Most of the larger companies were not examined by independent public accountants regularly. It was, in fact, notable when one was. Such examinations as were made were more often than not brought about by the uneasiness of credit lenders. Opinions of the independent accountants were short and to the point. They made no reference to any body of generally accepted principles because there was no authoritative codification.

In 1930, the American Institute of Accountants appointed a special committee to cooperate with stock exchanges in an effort to improve reporting—an event which was to have a profound influence on narrowing areas of difference in corporate accounting. The committee, under the leadership of George O. May who, for some years previously, had been accounting advisor to the New York Stock Exchange, was the first formal group to address itself in the name of the profession to the task of seeking ways and means to make the accounts published by corporations more informative and authoritative and to educate the public as to the limitations as well as the value of accountants.

The history of the committee work and its contributions are well known to most of you. We need not consider them fully this morning; in fact, there is time only to review their findings generally as a notable historical basis for subsequent accounting thinking in the field of our present interest.

The efforts of the committee, and the steps taken within the profession following and based upon its report, are generally credited with the avoidance of an undue extension of governmental regulation of the practice of accounting. Fortunately, the SEC which came into being during this critical period welcomed the opportunity to limit its functions. The foundations thus were laid for a peaceful and mutually helpful coexistence which has continued to this day.

The Alternatives: It was the view of the special committee that two possibilities existed for narrowing the areas of difference and eliminating inconsistencies in financial reporting. The first alternative would be to have a competent authority select, from the body of acceptable methods then in use, detailed sets of rules which would become binding upon all corporations of a given class. Under this alternative, financial reporting by all corporations would be patterned after the procedures which apply to regulated industries such as the railroads which are under the jurisdiction of the Interstate Commerce Commission and are required to follow accounting classifications prescribed by the Commission. The committee, without specifying reasons, stated its belief that the arguments against any attempt to apply this alternative to industrial corporations were overwhelming.

The Choice: It considered that a more practical alternative would be to leave each corporation free to choose its own methods of accounting within broad limitations requiring disclosure of the methods employed and consistency in their application from year to year. The Committee's conclusion was influenced, to a large extent, by its belief that it was relatively unimportant to the investor which precise rules or conventions are adopted by a corporation in reporting earnings if the investor was informed as to what the methods were and had assurance of the consistency of their application.

The Program: The committee concluded its report by recommending certain objectives to the New York Stock Exchange. I will not quote them in full but I believe, because of their importance, I should summarize them.

1. To encourage recognition of the fact that the balance sheet is not a representation of present values.
2. To emphasize that balance sheets necessarily are, to a large extent, historical in character and are largely the reflection of individual judgments.
3. To emphasize the relative importance of the income account and the recognition that it must be so presented as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the period to which it relates.
4. To require acceptance by corporations of certain broad principles of accounting which are regarded as having achieved general acceptance but to make no attempt to restrict the right of the corporation to select detailed methods of accounting.

At the request of the Stock Exchange the special committee suggested a revised form of independent public accountant's report, which achieved immediate acceptance in the profession. The opinion paragraph of this report for the first time related the fairness of presentation to the consistent use of accepted principles of accounting.

The Institute Accepts Responsibility: Promptly after the conclusion and publication of the correspondence, the Institute, in recognition of the need for a formal and continuous facility for considering matters in that field, appointed a special committee on the development of accounting principles. In 1938-39 the special committee was recognized and enlarged and has since been known as the committee on accounting procedure. Simultaneously, a Research Department was organized within the framework of the Institute staff. The committee's objectives, as initially stated, were:

1. To further the development and recognition of generally accepted accounting principles, and
2. To narrow areas of difference and inconsistency in accounting practices.

By these actions, the Institute acknowledged a responsibility and assumed leadership.

Procedural Rules: The newly created committee on accounting procedure adopted rules for its own conduct and guidance. In general, these provided that any opinion or recommendation before issuance is to be submitted to all members of the committee; that no opinion or recommendation would be issued unless it received the approval of two-thirds of the entire committee; and that any member of the committee who dissented from an opinion would be entitled to have the fact of his dissent and the reasons made a matter of record. The rules provided further that the committee should give careful consideration to prior opinions, to prevailing practices, and to the views of professional and other bodies concerned with accounting procedures before reaching a conclusion in a particular instance.

Unless formal adoption by the Institute membership is asked and secured, the authority of opinions reached by the committee rests upon the general acceptability of such opinions. It is recognized that extraordinary cases may exist in which departures from the opinions might be justified and it is understood that the burden of justifying any such departure must be assumed by those who adopt treatments other than those recommended by the committee. Certain other rules not particularly pertinent to this discussion also were adopted.

Membership in the committee is by appointment of the President. The committee consists of a chairman and 20 members. An attempt is made to see that a cross section of practice is represented in the committee membership.

Operation and Problems of the Committee: Since its creation, the committee has issued 48 Accounting Research Bulletins, the first 42 of which were reviewed, restated, and revised as recently as 1953. I would like to make it as clear as I can that my concern today has solely to do with our research methods and in no sense is intended to imply criticism of present or past members of the committee. The reasoning or the conclusions of the committee with respect to any one of these bulletins is not at issue here. My concern is with the need for a re-examination of the more basic question as to whether the procedures in use are those which are best designed to achieve our purposes.

Those in the Institute who, over the years, have had responsibility for the development of accounting research have recognized the importance of obtaining the views of industry spokesmen. They have tried to devise a procedural method which would achieve the purpose. They have not succeeded. The fault is not altogether that of the accounting profession; in fact, I think it rests largely upon a failure of industry to respond in any major sense its own obligations, and a disposition to interpret leadership by the Institute as an indication of willingness to assume full accountability.

Restrictions of Existing Research Methods: In the field of medicine pure research is largely in the hands of biochemists and other specialists and not in the normal province of the practicing physician. Techniques exist to test new drugs before they are offered to the public. In law, the continued acceptability of established concepts is tested each time a case goes to trial.

We have no comparable laboratory in which the new may be examined and tested against the old. This is a serious handicap to creative thinking. I cite as an example the interesting and important question of the continued validity of the assumption that in spite of its instability, the dollar is the best common denominator of accounting expression. You all know that strong conflicting views exist on this matter. We are told that, as a profession, we are remiss because we have not recognized economic developments. To the extent that such criticism implies negligence in considering the question, it is in error. You all know the validity of the assumption has received thoughtful and extensive consideration. Without at the moment raising a question of the merits of the conclusion, it is the present official position of the Institute that attempts to reflect the declining value of the dollar should, for the present, be achieved by supplementary data and explanations and not through the formal accounts.

Thus, an independent certified public accountant whose client would like to compute depreciation on a basis other than historical cost must advise his client that to do so would be contrary to the generally accepted principle involved and would require the accountant to so state in his report. It is my understanding that the SEC would view as deficient financial statements which were accompanied by an auditor's opinion qualified as to their conformity with generally accepted accounting principles.

Where We Now Stand

It seems clear that present processes permit little, if any opportunity for sound experimentation with new ideas.

To summarize, this is where I think we stand:

1. Although new events have created new differences and inconsistencies in the meantime, there is general recognition that the areas of difference and inconsistency in financial reporting have been narrowed substantially in the last quarter century and that this could not have been achieved except through the acceptance of the concept of a body of generally accepted accounting principles as criteria.
2. The Institute has accepted almost exclusive responsibility for the development of research in the field of accounting principles. In many respects this has been helpful but it certainly may not be said

to have been ideal. To the extent that research is conducted outside our Institute as, for example, that which finds expression in research statements issued by the American Accounting Association, it is not coordinated with our own.

3. Present methods of accounting research give no opportunity to test new ideas—in fact, there is some justification for a belief that they tend to stifle creative thinking.

A New Approach to Research: In a paper which I presented at New Orleans last fall and on which my remarks today are, in part, based, I proposed that the Institute undertake to restudy the research program. Solely to get started, I suggested that:

1. The development of accounting principles should be regarded as in the nature of pure research.
2. An adequate research organization should be provided. There are reasons which suggest that it would be best if the research organization were to be an adjunct to and not a formal part of the Institute itself. This is a basic question of policy which should be resolved in the restudy which I recommended should be undertaken. One possibility is to create a Research Foundation having the same organizational relationship to the Institute as does our present Accountants' Foundation.
3. The research organization should be staffed with personnel having proper academic and experience backgrounds (we might require as many as five or six men of outstanding ability). There should be no restrictions which would require that the staff be drawn exclusively from people who had been in practice; in fact, it might be preferable if the staff, in part, were composed of those whose background would enable them to contribute the academic and industry points of view.
4. Industry and our profession should jointly share the cost of the program in equitable proportions by contributions to the Research Foundation.
5. The function of the research organization generally should be to carry on continuous examination and re-examination of basic accounting assumptions and to develop authoritative statements for the guidance of both industry and our profession. In doing so, the research staff should have full power and facilities to consult, as necessary, with representatives of industry, with representatives of the teaching profession, and with representatives of regulatory

bodies. Representatives of such groups should have the *privilege* of presenting their ideas to the research staff. The functions of the research staff should also include the development and distribution of material designed to improve the understanding of those who rely upon financial reporting as to the nature, value and limitations of financial representations.

6. Statements issued by the research organizations should be submitted for approval or rejection of basic ideas to the Council of the American Institute of Certified Public Accountants. It would not be expected that Council would concern itself with form or manner of expression but only with the substance of the ideas presented for its approval or rejection. As a practical matter Council might appoint a "screening" committee to review proposals prior to their formal submission for voting.
7. Upon receiving approval of two-thirds of the members of Council voting upon any particular bulletin, it should be considered binding upon members of our Institute.

Research is a full-time job and should be recognized as such. Hundreds of the foremost members of our profession have devoted uncounted hours of hard work to the program of the committee on accounting procedure. Many of my own partners have served, and I know at firsthand of the tremendous demands on their time and energy. I am sure that all who have had the privilege of service have a well-founded conviction that their efforts were worthwhile. Yet I also believe that all of them at times must have wondered whether the job was not too demanding for any voluntary group. The necessity of changing the personnel of the committee from time to time is disruptive of continuity and this, too, is a problem.

Need for a Research Program

In spite of its devotion to its tasks, the ever-increasing complexities of business make it inevitable that we should be faced with the question of whether the committee can move fast enough to keep up with economic and social changes which affect accounting and financial reporting. The adoption of a program of the type which I suggest should permit an orderly division of the total responsibilities of the research organization and this should do a great deal to enable us to move forward with all necessary speed and the assurance of carefully considered judgments. One of our occasional mistakes has been to place too much emphasis on speed in getting out bulletins. This may strike some of you who are aware of the long periods of deliberation of the committee on certain problems as an unusual conclusion. Nevertheless, I think it is true that the few bulletins which have been most open to question are those where normal procedures were accelerated in an endeavor to meet a time schedule. Merely to change the organizational form under which research is conducted will not, of course, obviate the need to move with speed when the circumstances require that we should do so but a well-staffed research organization which can devote its full energies to a continuous process of research should be able better to anticipate the needs of the times and do a great deal to improve our capacity for prompt action.

Another problem inherent in our present methods of research is the difficulty of reversing positions previously taken. The need for doing so gives rise to awkward questions of procedure and protocol and tends to encourage procrastination. I believe that a research organization which, in a sense, would be independent of the Institute would have less difficulty with problems of this kind.

What We Are Doing About It: With the approval of the Executive Committee of the Institute in January, I appointed a special committee to restudy the whole subject of accounting research. The committee, under the chairmanship of Weldon Powell, a member of the firm of Haskins and Sells consists of: three other practicing accountants: Paul Grady of Price Waterhouse and Co., Leonard Spacek of Arthur Andersen and Co. and William W. Werntz of Touche, Niven, Bailey and Smart; two members from industry: Dudley E. Browne, Comptroller, Lockheed Aircraft Corporation, and Arthur M. Cannon, Vice President and Treasurer, Standard Insurance Company; Robert K. Mautz, Professor of Accountancy, University of Illinois; Andrew Barr, Chief Accountant of the Securities and Exchange Commission and Carman G. Blough, Director of Research of the American Institute of CPA's.

The committee's scope is unrestricted and its job, in essence, is to determine whether there is a better method of conducting accounting research than we now use. The committee members have exchanged views by correspondence on a series of basic questions framed by the Chairman. It has held one two-day meeting and filed a progress report with Council which is most encouraging. I have great confidence that the group will make a highly significant contribution in an important field where much needs to be done. When they have finished I think we all unquestionably will know more about the nature of accounting principles, the purposes which they serve, how they come into being, and how they are to be kept responsive to the needs of a changing economy.

A CRITICAL LOOK AT GENERALLY ACCEPTED AUDITING STANDARDS

By R. K. MAUTZ
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In 1947, the Committee on Auditing Procedure of the American Institute of Accountants published a *Tentative Statement of Auditing Standards*[1] in which nine propositions were offered, three as general standards and three each as standards of field work and reporting. A summary statement of these standards was approved and adopted by the membership at the annual meeting of the Institute in September, 1948. At the Institute's annual meeting in November, 1949, the membership approved a proposal concerned with the expression of an opinion by independent certified public accountants on examinations restricted in scope or requiring substantial qualifications for other reasons. The essence of this proposition found its way into publications as an auditing standard in 1954 when the original nine tentative standards plus this additional standard of reporting, 10 in all, were again published, this time generally accepted auditing standards.[2]

It appears that the first two words of this description, "generally accepted auditing standards," were well chosen. Although a considerable number of articles appeared in professional periodicals prior to 1947, some of them critical of the possibility of and need for a statement of auditing standards, little of a critical nature has appeared since the publication of the tentative standards in that year. Except for the addition of the one standard mentioned, the tentative standards proposed in 1947 were accepted without change and apparently with little or no criticism. It is the purpose of this paper to subject the 10 generally accepted standards to the critical study which they have long merited but have not as yet received. In defense of this critical approach, I hasten to add that it is intended to be constructive. It is hoped that out of such an examination may come a stronger, more useful, statement of auditing standards.

It may be well to put the present standards in perspective by briefly reviewing their history. How did they come to be? What was their purpose? How well do they fill the need they were developed to meet?

[1] *Tentative Statement of Auditing Standards,* American Institute of Accountants, New York, 1947.

[2] *Generally Accepted Auditing Standards,* American Institute of Accountants, New York, 1954.

The first published reference to auditing standards apparently is found in S.E.C. Accounting Series Release No. 21 which appeared in February, 1941. This release was aimed at improving the form and content of accountants' certificates and required that:

> "The accountants' certificate . . . shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; . . . ."[3]

Previous to this, the guide to an adequate audit was found in the pamphlet, *Examination of Financial Statements by Independent Public Accountants*[4] published in 1936 by the American Institute of Accountants. This pamphlet is the direct descendant of a proposal by the Federal Reserve Board in 1917 recommending procedures to be followed in the preparation and audit of the financial statements of manufacturing and merchandising concerns. Entitled "Uniform Accounts," this proposal first appeared in the April, 1917 issue of the Federal Reserve Bulletin.[5] It was issued by the Government Printing Office in pamphlet form in the same year[6] and reissued in 1918 under the more descriptive title, *Approved Methods for the Preparation of Balance Sheet Statements.*[7] In May, 1929 a revised version prepared by the American Institute of Accountants and entitled, *Verification of Financial Statements* was published by the Government Printing Office.[8] From 1932 through 1934, the American Institute of Accountants and the New York Stock Exchange carried on a substantial correspondence concerned with this subject[9] and finally in 1936, *Examination of Financial Statements* by Independent Public Accountants, a revision of the 1929 pamphlet, was published by the American Institute of Accountants.

[3] United States Securities and Exchange Commission, *Accounting Series Releases*, p. 38, United States Government Printing Office, Washington, 1956.

[4] *Examination of Financial Statements by Independent Public Accountants*, American Institute of Accountants, New York, 1936.

[5] "Uniform Accounts," *Federal Reserve Bulletin*, April 1, 1917, p. 70.

[6] *Uniform Accounting, A Tentative Proposal Submitted by the Federal Reserve Board,* Washington, for the Consideration of Banks, Bankers, and Banking Associations; *Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants,* Government Printing Office, Washington, 1917.

[7] *Approved Methods for the Preparation of Balance Sheet Statements, A Tentative Proposal Submitted by the Federal Reserve Board, Washington, for the Consideration of Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants,* Government Printing Office, Washington, 1917.

[8] *Verification of Financial Statements,* United States Government Printing Office, Washington, 1929.

[9] *Audits of Corporate Accounts, Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932–1934.*

As one result of its investigation in the McKesson-Robbins Case, the S.E.C. indicated its dissatisfaction with auditors' opinions which made no mention of this publication, yet which accepted it as authoritative in establishing their responsibilities. Release No. 21 reads in part:

> ". . . it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in a bulletin neither of which is referred to in the certificate."[10]

The year 1941 thus provides not only the first authoritative use of the term "generally accepted auditing standards," it also marks the point at which fairly detailed rules and procedures for financial statement examination and preparation were supplanted by less specific auditing standards. From 1941 until 1947, when the tentative standards were first published, a considerable expenditure of time and effort was directed at the development of auditing standards and a form of accountant's report that would refer to such standards satisfactorily.

With considerable accuracy, therefore, it can be said that our generally accepted auditing standards appeared as the direct result of pressure by the S.E.C. for improvement in the form and content of accountants' short form reports. But accurate as this claim may be, it is little more than a half truth. It can be contended with equal validity that by the late 1930's, public accountants as a group were becoming aware of the professional nature and stature of their work to an extent never before so generally felt. As happens at some point in the development of every profession, not just a few leaders, but a considerable number of practitioners began to comprehend and appreciate the social importance of public accounting and of professional responsibilities. The response in 1939 to the American Institute of Accountants' fiftieth anniversary essay contest on the subject, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" and the Sanders, Hatfield, and Moore monograph, *A Statement of Accounting Principles*[11] are indications of this.

The profession was ripe for such efforts as the development of professional standards. The McKesson-Robbins Case and the S.E.C. may have forced the issue a few years earlier than would otherwise have been the case, but the pressure was certainly mounting. The explosion of interest

[10] *Accounting Series Releases*, p. 37.

[11] Sanders, T. H., Hatfield, H. R., and Moore, U., *A Statement of Accounting Principles*, American Institute of Accountants, 1938.

in principles, standards, and professional responsibilities which even the second world war could not stem was inevitable and would not have delayed much longer even without the timely urging of the S.E.C.

Therefore, the purpose of the auditing standards developed by the Committee on Auditing Procedure cannot be described as merely to meet the pressure exerted by the Securities and Exchange Commission. This was perhaps the immediate incentive, but the real purpose must be viewed as something far more fundamental and long-range in outlook. This more basic purpose might be expressed in a variety of ways, but stated simply, it was to raise the level of professional performance. If we look closely at the nature and purpose of standards, it becomes apparent that such must be their real function. As defined by C. A. Moyer, "Audit standards are criteria or measures of performance which are established by authority or general consent as general guides to action. They imply a degree of uniformity in quality of performance."[12] Standards give to all concerned an indication of what is required if a given examination is to be considered adequate in scope and performance, and by so doing help to raise the general level of professional practice.

This basic purpose of auditing standards can be made more specific by considering the needs of the different groups concerned with professional performance. Standards should provide guides:

1. For the evaluation of professional performance by practicing public accountants.
2. To indicate accepted requirements of practice to those outside the profession who have occasion to judge or evaluate the work of practicing accountants.
3. To suggest the extent and nature of education expected of those preparing for entry into the profession.

Thus generally accepted auditing standards, if they adequately fulfill their function, provide the practicing accountant with a basis for self-review, a means of evaluating his own work so that he may determine whether or not he is satisfying his professional responsibilities. They should give courts, commissions, and other interested parties a reasonably clear indication of what professional accountants hold as required in the adequate performance of an examination of financial statements. Finally, they should be useful to teachers and students for educational purposes. From the

[12] Moyer, C. A., "Audit Programs and Standards, Principles, and Procedures," *The Journal of Accountancy*, December, 1952, p. 687.

standards, it should be possible to determine what a student should know and understand in order to be considered sufficiently well trained to be useful on professional assignments.

A frank evaluation of the 10 generally accepted auditing standards finds them unsatisfactory for these purposes. Their issuance met the demands of the S.E.C. and satisfactorily fulfilled the immediate need; it is extremely doubtful, however, if they have been effective in raising the level of professional performance in any substantial degree.

This rather harsh assertion cannot be proved empirically, but a hard look at some of the standards themselves leaves one with little room for disagreement with this unhappy conclusion. Take, for example, any one of the general standards. The first reads:

> "The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor."

If one seriously tries to take the point of view of an outsider, he is likely to read this standard as saying that an auditor ought to have enough training and experience to know what he is doing. This seems so obvious a requirement as scarcely to justify repetition. But how much technical education is required? How does one measure the required proficiency? Just what are the standards by which these desirable characteristics are judged? How can one tell if a given auditor does or does not have adequate technical training and proficiency? No help is given on these pertinent matters.

Standards (2) and (3) in this group are no more helpful. They read:

> "2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
>
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report."

In short, an auditor must be independent; he must exercise due care in his work. But how does a young practitioner judge his own extent of independence? When has he overstepped the bound and lost this essential characteristic? Can we give him no help here at all? And is not "due care" another obvious requirement, so obvious, in fact, that failure to specify what it means robs this standard of any real significance?

This type of question can be directed at the standards of field work with equal validity.

"Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient, competent, evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination."

Does any one of these really add to an inquiring reader's knowledge of what is required in an audit examination? Is a judge, a member of a jury, an accounting student, or even a practicing accountant substantially more able to judge professional performance after reading these standards than before? The use of such qualifying terms as "adequately," "properly," "sufficient," and "reasonable" in propositions as general as these come close to relieving them of all effectiveness. Do these statements give any real guide to a beginning practitioner with respect to the extent of his internal control review or the kinds of evidence he can rely on? And if they do not do these things, are they fulfilling their purpose? Can they raise the level of professional performance?

The standards of reporting, for some reason, are of a substantially different character. These are much more specific than those relating to performance of the examination. The first one reads:

> "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting."

Although we have never satisfactorily stated the "generally accepted principles of accounting," this standard is clear and to the point. A specific statement on a specific subject is required in the audit report. Without it, the report fails to meet the standard. In effect, this is a rule. The third standard in this group is much like those given in the other two groups, so unspecific as to be of little help:

> "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Numbers (2) and (4), like number (1), are sufficiently specific to have meaning.

> "2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
>
> "4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clearcut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

In short, our 10 standards divide themselves into two groups. Three of them, all related to reporting, not only are fairly specific, but are in the nature of rules; the other seven are so general and include so many qualifying terms as to be of little informative value to anyone. It is on this fact that one can challenge their usefulness as standards. How can such indefinite statements serve as guides to anyone? How can such belaboring of the obvious raise the level of professional performance?

Although the question of why we have such indefinite standards appear to have little to do with improving the situation, it is still an intriguing one, and an answer may help us avoid a similar error again. One very likely reason is that we have a confusion of principles and standards. *Generally Accepted Auditing Standards* points out that in discussions with the Institute Committee, the Commission stated:

> "Auditing standards may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures . . . ."[13]

This unfortunate confusion of terms may have led to the selection of these broad, general statements not at all suitable as standards. Another reason for the development of standards in the form that we now have them could be a desire to avoid the specific type of instruction found in *Examination of Financial Statements*, previously the "standard" for evaluation of auditing performance.

Of course, these are surmises at best, and the more important task is to consider the standards themselves. What, if anything, should be done with them? Should they be abandoned, revised, modified, or left as they are?

[13] *Generally Accepted Auditing Standards*, p. 12.

Here I must be careful to make my position clear. I feel that we have a real need for auditing standards. For the reasons stated earlier, to raise the level of professional performance, to guide practitioners, students of accounting, and those who must judge the efforts of practicing auditors, we need good standards. The fault of our present standards is not that they exist; it is that they do not go far enough in fulfilling their purpose. They fall short of providing the guides that are urgently needed. Rather than abandoning our present standards, I urge they be supplemented and expanded. They tend to mark out the general areas in which guidance is needed; let us now develop more useful guides within these areas. Let us develop, for example, supplementary standards indicating the nature of competent evidential matter, and, if possible, guides for evaluation of the sufficiency of evidence in specific cases. Let us indicate what is comprehended in a proper study and evaluation of internal control. Let us indicate more specifically the characteristics of independence, in order that its presence or absence may be judged. Except for the standards of reporting already noted, it seems entirely possible that supplementary standards can be developed to support and expand each of the present standards.

Some may fear such a proposal as this on the grounds that it will result in rules and regulations that will regiment the profession and hamper the exercise of essential judgment. This is an eventuality that could occur, of course, but there is no reason why it must. The line between too little and too much restriction is a fine one, but it is the task of standards to seek this out and mark it as clearly as possible. The present standards themselves are restrictive; they require that certain conditions be met. Any effort to raise professional standards must be restrictive, but this in itself does not eliminate judgment. For example, the decision of *whether* to review internal control has been eliminated by the present standards; an appropriate review is required. The much more difficult question of *how* to review internal control in each of many examinations still exists, and its solution calls for the skillful exercise of judgment in each case. Similarly, due care is required, but choice of methods of exercising it is left to the auditor. Thus standards curtail judgment in one area but avoid infringement on this professional characteristic in others.

Expansion of the standards as recommended here should be almost completely in the direction of limiting judgments with respect to whether or not a given step should be taken; seldom should standards infringe in any way on the exercise of judgment concerned with how to proceed with performance of the required step. Restriction of the "whether" type of judgment is required if the level of performance of the profession is to be raised; freedom of choice with respect to the "how to do it" type of decision is essential to maintenance of the professional stature of accountants. Any attempt to develop supplementary standards should recognize these fundamental limitations.

What we need is considerable study of our present standards. To what extent do they provide the guides we need? In what respects do they fall short? How can they be expanded or supplemented so that they may become effective standards to measure, evaluate, or teach professional performance? How can these supplementary standards be worded so that they offer guidance to a practitioner or a student without unduly limiting judgment and freedom?

As an illustration of what is intended by supplementary standards, let us direct our attention to the third general standard. "Due professional care is to be exercised in the performance of the examination and the preparation of the report." As suggested previously, this standard offers little real guidance. Can we indicate the nature and meaning of due care in audit work any more definitely than this? Can this standard be supplemented by one or more statements indicating specific points at which care is required, and the nature of the steps to be taken in the exercise of professional care? Certainly the members of the committee responsible for this standard had something more in mind than a vague thought that one should be careful in the performance of professional work. Unless we are completely inept with words or seriously incapable of expression, we should be able to state these thoughts as guides for those who perform such work.

It seems likely that the members of the committee had in mind such essentials as the need for alertness at all times while performing audit tests, the importance of recognizing inter-relationships among accounts and accounting data, the fixing of responsibility for work completed, the amount and extent of review reasonably required to reduce the possibility of error on the part of the audit staff, and similar matters. Stated in the form of supplementary standards, these might appear somewhat as follows:

1. Alertness to the possibilities of errors and irregularities and to the implications of inter-relationships in the data under review is required of all members of the audit staff at all times.
2. Acceptance of responsibility for work performed, and indication of such acceptance, is required of all members of the audit staff.

3. A review of the audit program should be made by a competent and responsible person subsequent to and based on study of the internal control in effect and prior to completion of the field work.
4. A review of the work papers and audit work of each man should be made by a competent and responsible person before completion of the field work.
5. An evaluation of the significance of every error and irregularity discovered during the course of the examination should be made by a competent and responsible person. Every material error and discrepancy, including any implication of other errors and irregularities, should be investigated completely.
6. Particularly difficult or unusual problems arising during the examination should be referred to a qualified specialist, or at least discussed with competent and responsible persons.
7. The audit report should be reviewed by a competent and responsible person and consideration given to the adequacy of work paper support before the report is released.
8. Provision should be made for report checking and proofreading as necessary to give reasonable assurance that clerical and typographical errors in the finished report have been eliminated or reduced to a minimum.

Most of us would agree that failure on any one or more of these points would indicate lack of due professional care. These requirements carry us beyond the basic standard and help us to get at the meaning of due professional care "in the performance of the examination and the preparation of the report." They indicate the points at which care should be directed; they do not specify how the care is to be implemented; thus they fall within the proper boundaries of professional standards.

Some may challenge these statements on the ground that they are as general and indefinite as the basic standard; others may contend that they are overly restrictive. I think that neither of these charges is completely justified. By specifying points of attention and general methods of approach, they add much to the clarity of the original standard. By refraining from detailing the procedure to be followed, they avoid undue restrictivenss. I think these or similar propositions could help in raising the level of professional performance by giving desirable guidance to practitioners, students, and others.

It should be clearly understood that these are not, as they stand, submitted as supplementary standards. They would require a great deal of intensive consideration and probably modification or revision before they would warrant such a claim. They are offered here merely as an indication of how supplemenatry standards might be developed. The ones suggested here may be too few or too many, too general or too restrictive. They do, however, indicate the general nature of supplementary standards and the purpose which supplementary standards could well serve, once developed and accepted.

Are such supplementary standards really needed or are they something we can get along without for a good many more years, just as we have in the past? A realistic answer to this requires a little soul-searching and self-criticism by the profession. It can be contended that accounting tends to delay until it is actually in difficulty or at least under pressure before ever seeking any remedy. The profession was ready for the development of auditing standards, true, but nevertheless it did wait until urged by the S.E.C. before making any real progress. The impetus for development of *Examination of Financial Statements*, a publication of unquestioned benefit to the profession, came originally from the Federal Reserve Board. To a greater extent than we like to believe, the story of progress in accounting is a record of important cases in which accountants appeared in an unfavorable light. Mr. Saul Levy has pointed out the possibility of having standards for the review of internal control forced upon us by a jury of laymen if we neglect the development of such standards ourselves.[14] Certainly this may be possible in other areas as well. Indeed, a question may be raised as to whether we can claim true professional standing if we do not have realistic standards for the evaluation, improvement, and policing of our professional work. It seems to me that the need for such standards and the obvious dangers in foregoing their prompt development are such that we should lose no time in commencing what may be a long and arduous task.

How are such standards, if they are desirable, to be developed? The first thought, of course, is that a committee, either one now in existence or one formed for the purpose, be assigned the task. But in my opinion, this approach does not offer the greatest promise of success. We are not yet ready for committee activity in this area. First, we need a great deal of preliminary and exploratory work, a great many interested members of the profession, working alone or in small groups, attempting to express as clearly and as concisely as possible their interpretations of the 10 generally accepted auditing standards. Committees, by nature, can do little

[14] Levy, Saul, "Internal Control and Legal Responsibility," *The Journal of Accountancy*, February, 1957, p. 31.

more than consolidate progress; the initial gains in a field such as ours come primarily through the research efforts of individuals or small groups. Not until this subject has been intensively studied by a goodly number of keen minds and the results of such studies made available for discussion and criticism will we have reached the committee stage in the development of supplementary standards.

Now what does this all add up to? First, I think the present 10 generally accepted auditing standards are not adequate for their purpose. They tend to be either rules on specific reporting practices or such general, indefinite requirements as to be of little benefit in raising the level of professional performance. Second, there is real danger in maintaining to ourselves and to the world that these pleasant generalities are the only professional standards we need. Public accounting has an unfortunate history of moving only when it is moved upon. Imposition of standards by outside pressure of whatever kind is surely less desirable than developing and establishing our own. Third, the present generally accepted standards can serve as a basis for the development of a series of supplementary standards to provide more specific guidance than is now available. Such supplementary standards need not interfere in the least with the exercise of appropriate professional judgment, and they are fundamental to any serious effort to raise the level of professional performance. Every member of the profession, particularly if he is in full time practice, has an opportunity to make a real contribution to this development through analyzing carefully his understanding of the present standards, offering suggestions for their modification, and working in every way possible toward their clarification and expansion. I think this is as important a task as faces the profession. We would do well to get on with it.

ACCOUNTING AND NEW MANAGEMENT ATTITUDES

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Any profession must continually grow in scope and nature, if it is to adjust to changing requirements and evolving knowledge. Just as any practicing professional must constantly challenge and reappraise his own work, the profession of which he is a part must frequently challenge its position and goals.

Accounting as a profession, in its 50 or 60 years of organized development, has made tremendous strides. It has advanced from an initially clerical function to an important role in the management process. In the area of auditing, for example, this advance has enabled the profession to cast aside its original attitude of item-by-item verification for a sophisticated judgment appraisal of financial statements in terms of broad principles.

Perhaps the most encouraging characteristic of the profession's growth, to this time, is its involvement at the policy level in business organizations. The industrial accountant is an important member of the management team and hence is involved in considering all phases of business operation: production, marketing, and research, as well as finance. The public accountant is repeatedly called upon for consultation on matters of policy significance. It is largely the future of this latter phase of accounting which I should like to consider today.

In my view, a changing approach to the analysis and solution of problems is evolving in the business world. There are two principal characteristics of this movement. First, informed management is taking a more scientific approach in searching out basic relationships which underlie decisions within an enterprise as well as across industry. Second, modern business management is attempting more and more to use the tools or methods of other disciplines in the analysis of its own problems. This approach by industry involves the use of new techniques—from mathematics, electronics, and the social and the natural sciences generally. These new developments and new techniques are pointed in the direction of replacing with more adequate and more objective methods, many of the present largely judgmental bases for operating decisions.

Minimally, it is the accountant's obligation to become familiar with these new attitudes and techniques. Further, it is the accountant's responsibility to participate in their formulation and development. But even more importantly, the accountant must assume responsibility for critically and objectively approving each such development in terms of its potential relevance for managerial purposes. Only by so doing can the accountant fulfill his professional responsibility continuously to improve management's techniques for decision-making.

Interestingly enough, the new management approach is dependent for its success upon an increasingly broad base of objective data, such as costs, which come from the accountant's own area of practice. It is, therefore, more logical, as well as most desirable, that the professional accountant have a principal role in the experimentation with, and the utilization of, these new techniques.

A Look at Contemporary Accounting

A logical point at which to start in appraising the future role of our profession is to make a critical examination of some of the basic concepts which underlie present practice.

It has been said that accounting is "the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."[1]

This definition emphasizes the standards of fiduciary responsibility or stewardship which the accounting profession has taken so seriously. However, for the purpose of this paper, that definition of accounting is too narrow and too static. It restricts the discipline of accounting to very limited confines. For example, the definition treats only indirectly of the responsibility of the accountant in the decision-making process.

A broader way of thinking of the profession is much closer to the general definition of a discipline by Dewey. He has said that a discipline may be defined by reference to the problem (or subject matter) with which it is concerned or by reference to the methods (or tools) which it uses.[2] Perhaps this definition should be expanded to add that recognition should also be given to *point of view* and to *responsibility involved* in the practice of the discipline. Dewey's definition, however, enables the area of a discipline to expand and grow as methodological advances are made. The bur-

[1] American Institute of Accountants, *Accounting Terminology Bulletins*, No. 1, August, 1953, p. 9.

[2] "Unity of Science as a Social Problem," *International Encyclopedia of Unified Science*, Volume I, Part I.

den of this paper is to demonstrate that the discipline of accounting has an opportunity, and hence an obligation, to widen its area of subject matter and study.

The accounting profession is at this time perhaps too preoccupied with the stewardship phases of its responsibility. It has set standards and principles, for the benefit of all, which have done much to improve financial reporting. It is possible, however, that the current emphasis on the fiduciary aspects of accounting has underplayed the proper role of accountants in the decision-making process. It is, in fact, possible that the strong emphasis on the standardization of reporting practices has worked to the disadvantage of management in its attempt to generate data and information generally useful in the process of daily business decisions.

Take a brief look at lifo, for example. The original fifo philosophy for inventory valuation was definitely useful in fulfilling the stewardship phases of accounting. In the interests of doing a better job of matching current costs with current revenues and in the interests of conserving resources, the lifo technique was developed. However, acceptable as lifo may be for these latter purposes, lifo in its basic form is gravely deficient as a technique for making day-to-day decisions about inventory policy. There is probably no company which keeps its basic inventory records in terms of lifo cost. Actually, the only really useful inventory technique from a day-to-day decision-making point of view, is nifo (next-in-first-out), or some variant thereof. Nonetheless, as a profession, we have done little to encourage exploration of such inventory techniques as nifo which might be genuinely useful to business management in terms of inventory control and relaxed policy decisions.

Closely related to the field of inventory control is the design and development of cost systems. Cost accounting techniques were one of the first highly developed accounting procedures and remain a significant management control device. Presumably, their principal purpose is to aid in making daily policy decisions. However, an almost standard item in any internal control questionnaire is this: "Is the cost system tied into accounting controls?" I think the proper question is whether a cost system is useful for management control purposes. It is questionable whether a useful cost accounting system can or needs to be tied into the accountant's over-all principle of historical costs. Perhaps an improved concept of cost accounting would be one involving theories of replacement and opportunity cost, which approach would necessarily remove the cost accounting system from the general frame of reference of historical costs.

To back a bit, the evolution of accounting has been accompanied by a continuous refinement of the theory of double entry bookkeeping and control accounts, even though the neatness and logic of this discipline is not appreciated as much outside the profession as it should be. The accountant has developed to a high art many detailed techniques, including cost accounting, which are considerable accomplishments. The accountant has made a significant contribution in day-to-day management control decisions and business policy-making, because of his ability to understand and to manipulate data generated within a business. But now it seems the accountant must come to understand that the underlying functions which these same data and procedures were designed to serve can perhaps be served more fruitfully by a variety of new techniques not heretofore available.

New Management Attitudes

Decision-making in business, as in life, is in a way planning a strategy on the basis of incomplete information. In my experience, there is an increasing interest on the part of business in exploring analytically its internal operations with a view towards improving its decision-making. This approach, which it is at least convenient to refer to as *operations research* or *management science*, involves qualitatively no different approach to the analysis of problems than has been used by accountants in the past. However, operations research has made available an entire array of new quantitative methods or techniques which have not heretofore been either studied or applied by business.

By way of simplification, it might be said that, in the past, management has been forced to isolate a single variable and to predict what would happen to operating results in terms of the various possible movements of that variable. The techniques of operations research permit the simultaneous manipulation of a number of variables. For example, assume a manufacturing and distribution problem involving varying production costs in a number of factories, differential transportation costs, and a seasonal pattern in both manufacturing and sales. Obviously, it is possible, by present methods, to minimize production costs or to minimize transportation costs, separately. However, the real solution to the problem (made possible by management science techniques) involves an interdependent analysis which yields a maximum profit after giving consideration to all sets of variables.

Another development which has fostered and will continue to encourage the interest of business in scientific methods is the availability of electronic data-processing equipment. The phenomenal development of E.D.P. equipment has made possible the tremendously quick processing or analysis of volumes of data which, heretofore, was simply not possible by manual means. Interestingly enough, however, the most important aspect of the E.D.P. movement is not that such equipment can process data quicker and faster than any other method. Rather, the really significant fact is that such equipment permits use of many of the techniques made available by operations research.

In combination, the new-found interest of business in the scientific method and the new-found ability of business to use operations research techniques by adoption of E.D.P. equipment is certain to have a powerful impact upon the business community in the immediate future.

In order to demonstrate these new attitudes and interests of business, a brief case history may be helpful. As the story unfolds in this case study, note that, during a period of less than 10 years, a complicated inventory system has changed from a burdensome manual and judgmental operation to an integrated E.D.P. procedure, involving sophisticated mathematical methods.

In a large firm, a widely scattered and heterogenous inventory presented a considerable problem for both accounting and for operations. The particular inventory consisted potentially of 500,000 different items running from nuts and bolts to major units of machinery. The inventory was on lifo and the double pricing of that inventory by the more usual methods had come to be a significant problem involving burdensome clerical calculations. Roughly, seven or eight years ago, the mathematical technique of statistical sampling was applied to the solution of the lifo valuation problem. A probability sample was designed which developed a price index for both tax and accounting purposes. This index was completely acceptable to management and to external agencies. Adoption of the statistical sampling approach saved roughly 50 man-years of expense annually, in the valuation phase of the problem. But, most importantly, the sampling techniques produced significant additional benefits in the sense of more adequate and more timely results—useful for many purposes over and beyond inventory valuation.

More recently, this same inventory has been completely incorporated into an E.D.P. system. The E.D.P. inventory system is all-encompassing. It involves preparation of the purchase order, payment of invoices, accumulation of all inventory records in terms of both dollars and units, and preparation of sales invoices. However, the most important phase of this E.D.P. conversion relates to the integration of mathematical methods into the inventory control system. Suggested order points are determined by a mathematical manipulation of past sales experience. Recommended order quantities are determined by a mathematical consideration of the interrelationship between the cost of placing and processing an order, the investment cost of carrying inventory, and the difference in cost which would be involved in varying quantities of purchase.

This is the system as it stands now. But consider the possibilities after some experience has been gained. Perhaps linear programming may be the answer to determination of concentration stocks and relocation of stores. Perhaps new and better mathematical methods can be devised to determine proper order quantities. Perhaps the unit method of inventory control can be abandoned, if a variable affecting large groups of inventory can be identified. With the tremendous speed and versatility of E.D.P. machines, all of these possibilities can be considered as practicably capable of achievement on the basis of routinely generated data. Obviously, these possibilities could not have been considered under the more conventional accounting techniques available in the past.

Again in the inventory area, a recent article in an accounting journal told the story of determination of physical inventory valuation by statistical techniques. Inventory valuation, as we all know, is at best a good guess. Why should we count every nut and bolt as in the past, and why should we price them up on the basis of detailed unit costs? In this particular case, only a portion of the inventory was counted and priced. An estimate of the entire inventory valuation was developed from a scientifically selected sample. The time savings and the cost savings to be generated from the use of this same estimation technique throughout industry could be tremendous. But consider the real potential of this technique. Perhaps cost accounting for the units involved should also be developed on the basis of a sample of items. Perhaps the sample selection procedure could be extended to the area of special analyses, such as cost trends, profit contribution, and so on. Note that this approach not only involves savings in the course of synthesizing data, but it would also make possible more adequate, more timely, and more meaningful data for control and decision-making purposes. These possibilities are not mere fancy. Such a sampling technique for cost analysis has, in fact, been recommended for use in a large governmental agency.

The implications for the profession in inventory situations such as these are fundamental, and require re-examination of currently employed practices in relation to possible alternatives which are already available. In the first place, the professional accountant as an auditor must understand, and to a limited degree he must be able to apply, these new techniques in order to audit the results knowledgably. Secondly, the professional accountant must have knowledge of these new management devices in order to be able to expand his role as a contributing member of the management team.

The Nature of Future Accounting Developments

At this same conference last year, Thomas H. Carroll, Vice-President of the Ford Foundation, made this statement: "A practicing profession does not make substantial forward strides through the perfection of minor procedures, but through scientific discoveries and new insights which sometimes seem of little immediate relevance to current practical problems."[3] Carroll's comments point up the accounting profession's responsibility in relation to new developments in business management. The accounting profession is going to have to consider a number of basic points in order to keep pace with, or preferably move ahead of, these new developments in business management.

First, the accounting profession is going to have to give serious consideration to the interrelationship of the various information systems which are involved in a business organization. For example, the financial requirements for inventory valuation, in the historical sense, must find their proper place as part of the requirements for inventory data useful for general operating decisions. Specifically, if a unit cost determined for lifo purposes is not useful in making day-to-day decisions, then the lifo system of costing must either become a separate system for financial and tax purposes only or it must be revised, adapted, or integrated into an inventory valuation system which is, in fact, useful for business decision-making purposes.

Secondly, accountants must recognize that the optimum operation of the total entity is not necessarily the simple sum of optimum operation of the components of the entity. New tools which permit the manipulation of multiple variables will permit the realization of this long-recognized, but until the present, unobtainable goal.

Third, problems of production, sales, inventory levels, and capital requirements are all interdependent. Present accounting practice provides the common denominator of the dollar in evaluating each of them, but there are sometimes non-monetary variables which must be considered. For example, in an inventory control situation, the psychological effect of an "out-of-stock" transaction on a customer may have a long-run impact on sales.

[3] "Education for Business—A Dynamic Concept and Process," *The Accounting Review*, Vol. XXXIII, No. 1, January, 1958, p. 7.

Some measurement of or control over the non-monetary stock-out factor must be worked into an effective inventory control system.

More broadly, the profession must consider the demarcation of the subject matter of accounting. Is accounting's typical preoccupation with historical costs, in terms of rigid standards and principles, applied across all businesses, in fact compatible with the requirement that accounting data be useful in the decision-making process? Obviously, we cannot and should not discard the progress which has been made, but perhaps a re-examination of some of our present accounting principles and standards in a broader frame of reference is in order.

As accountants, we must have a complete understanding and give constant recognition to the evolution of new tools made possible by evolving scientific methods and E.D.P. systems. Use of these tools by business can only broaden the scope of our professional contribution to business. The use of most of these tools constitutes nothing more than a logical extension of our present activities.

It seems to me that, in many cases of present practice, standards are set in terms of cases, instead of principles. It should be hoped that wherever possible, in accounting or in auditing, we can search out and perhaps restate some of the principles which, in fact, underlie our practice. The consideration of statistical sampling for auditing purposes is a case in point. Judgmental sampling is not going to be discarded tomorrow. But, systematic examination of the possibilities of statistical sampling has already done much to clarify the purposes of the audit function. Futher, this systematic study has demonstrated some of the areas in which the further development of probability sampling is required.

None of these impacts upon the accounting profession will change our professional practice overnight. Perhaps some of the questions raised here are only peripheral. One possible conclusion of the profession may be (although it seems doubtful to me) that financial accounting in the stewardship sense is an information system unto itself, and that our present reporting standards are, in fact, incompatible with the broader approach to decision-making. More likely, the accountant in making his contribution to the development of these new business approaches will find ways and means to combine the stewardship and the decision-making requirements of management into a single information system.

There are no pat solutions to these queries available today. The point is only that the profession must force upon itself a continuous self-appraisal in terms both of our present objectives and presently available techniques. It must also be prepared to take the action necessary to search out and develop new techniques. We can make a considerable contribution to the advancement of management science because of our special knowledge of, and facility with, business data and information systems. Further, only by combining this knowledge with the special abilities of the management scientists will the "new approach" to management have any real chance of success, because the proponents of management science cannot "go it alone."

Responsibilities of the Profession

The profession presently has the need to bring new tools and methods to bear in the solution of decision-making problems. This is not a new responsibility. There is, however, a new urgency involved, because of the seeming flood of new technical possibilities being considered by business.

Most importantly, it seems to me, the profession has the responsibility for testing and evaluating these new tools prior to their use. A case in point relates to current interest in the field of statistical sampling. There have perhaps been no more than a handful of people who have written extensively on the subject. The individual practitioners and firms actually using the techniques of statistical sampling are perhaps even less in number. Nonetheless, the American Institute has set up a committee for study of the technique. Such an approach, which involves a pooling of experience and diverse points of view, is a sound and mature way to analyze all new techniques, whatever their ultimate role in the profession may be.

Somehow or other, the accounting profession must undertake new and systematic research on a fundamental level. Far too often, professional groups have made codifying statements about practice as it has evolved. Rather, the profession, as well as its individual members, should be involved in research which results in suggested changes before business has found the techniques and presented them to the profession. Again, we must move ahead and stay ahead of business practice and requirements, being mindful of the everyday changes in management needs.

As an example, one of the areas in which I think this basic research is required almost immediately is that of internal control. Our entire opinion procedure is based on the concept of internal control and the interplay of information systems and decision-making processes. Yet there is very little explicit information in our literature about either the detailed mechanics of internal control, or the exact relationship of internal control to our auditing objectives and procedures. Couple this circumstance with a significant oncoming change in the concepts of control within a business, and one is confronted with a considerable impact upon both the auditing profession and the controller's function.

Finally, as a matter of great importance, the profession must stimulate research in academic institutions. In their hurried daily existence, and within the contraints of their academic and intellectual backgrounds, accountants can do little to make fundamental progress in basic research. There are many answers we need and must find. In many ways, all of us must be re-educated if the change in business attitudes and business concepts moves forward as now seems likely. For this basic research and for the reorientation of the profession, we must encourage and support independent activity of the academicians and their business schools.

Analogous remarks apply to teaching and to current content. We should encourage business schools not to devote their total teaching effort to what accountants are now doing. Rather, we should encourage them to emphasize in the classroom what the profession should be doing and what it will be doing in the future.

CONCLUSION

The accounting profession has played a significant role in the development and continuous improvement of financial reporting techniques. The profession has also had in the past a strong hand in the formulation of business policy. If management's interest in new attitudes involving the use of scientific and mathematical techniques continues, the accountant must extend his abilities and knowledge in order properly to perform his function. Moreover, accountants, already expert in the area of information systems, costs, and other financial data, have as a profession, the opportunity to become a strong influence not only in encouraging the use of these new techniques but in their actual development. This responsibility is typically and fortunately a professional responsibility involving aspects of challenge and re-appraisal. As a profession, we must find ways and means to engage in fundamental research which will support that movement and carry it forward.

SECOND SESSION

THURSDAY, MAY 15, 1958—12:30 P.M.
The Ohio Union—East Ballroom

Presiding:

RUDOLF BAUHOF, *President, The Ohio Society of Certified Public Accountants; Partner, Ernst & Ernst, Cleveland*

Presentation of The Ohio Society of Certified Public Accountants awards to the highest candidates in the Fall 1957 CPA examination made by LEONARD L. HOPKINS, *Chairman, Committee on Accounting Education, The Ohio Society of Certified Public Accountants; Partner, Keller, Kirschner, Martin & Clinger, Columbus,* to:

THOMAS WILLIAMS, Cincinnati
GEORGE ABS, Dayton

THIRD SESSION

THURSDAY, MAY 15, 1958—2:00 P.M.
The Ohio Union—West Ballroom

Presiding:

HAROLD W. SCOTT, *President, National Association of Accountants; Partner, Haskins & Sells, Detroit, Michigan*

Paper: "Economic Forecasts in Decision Making"

LESTER S. KELLOGG, *Director of Economic Research, Deere & Company, Moline, Illinois*

Paper: "Marketing Research—Vital Advance Planning Tool"

THOMAS G. MACGOWAN, *Director, Advance Planning Division, The Firestone Tire & Rubber Company, Akron*

Paper: "Profit Planning"

PAUL L. NOBLE, *Assistant Comptroller, The Ohio State University, Columbus*

ECONOMIC FORECASTS IN DECISION MAKING

By Lester S. Kellogg
Director of Economic Research,
Deere & Company, Moline, Illinois

It is indeed a pleasure to be in Columbus today. To be back at The Ohio State University is like home-coming. Some of you remember that I spent a number of years here in the School of Commerce and specifically in the Bureau of Business Research. I remember helping to organize several of these types of conferences in the late 1930's. As I have had a chance to review their programs since those days, I cannot help but be impressed with the great service that the University and the College of Commerce is providing in making such sessions possible for business and professional people of the state of Ohio. I am glad today to be able to participate but am extremely humble in coming before this particular profession.

In appearing before you today I feel much as the clergyman in one of the large churches near Chicago who recently told the story of his junior high school daughter with whom he was alone at breakfast one morning. Conversation got around to what was going on at school. The young lady described with enthusiasm her most recent participation in a group discussion over some of the problems of current interest: the space age, world peace, modern youth, etc. In the easy flow of language about such subjects, the girl suddenly looked straight at her clergyman dad and said: "Dad, as an outsider, what do you think of the modern world?"

I feel very much today as I imagine that clergyman did at that breakfast table. As an outsider, I am here to talk about some problems closely related to your special province of work. I hope you will forgive the apparent presumption involved in my talking to you about these subjects.

The subject of my talk was formulated under some trying circumstances, and it may be misleading. What I am going to say to you could be described by any one of several other titles. One that I wish I had suggested (with no notion as to whether the program arrangers would have accepted it) is "Prophecy, Prediction and Projection."

I

Every important decision in modern business is based on a prophecy, prediction or forecast. The business executive is seldom conscious of this fact in what he considers his operating day-to-day orders, answers to questions, or interpretations of policy. Examination of businessmen's short-range forecasts indicates that they usually expect a continuation of the most recent trend. The businessman is apt to be a little more aware that he is forecasting and that he most takes account of other than short-run forces if he is drawing conclusions, making recommendations to his board or carrying out plans involving large-scale financing, long-term contracts or major infrequent changes in policy or the purposes or direction of his business.

It is an inherent quality of humans, however, to look toward the future in their general planning even though their appraisals of the future may not be specific. Prophecies were the guides for the tribes of Judea, according to our Biblical record. They were the bases of teaching, strengthening of morality and hope. Throughout history, prophesying and foretelling have been important functions of those skilled in such arts. Broader bases of learning and education, together with the passage of time and the speeding up of the pace of our lives have reduced the importance of long-range artful prophecy and have given greater importance to short-range rationalized predictions and trend-supported and reasoned long-range projections. I want to limit myself to the last of these.

The market among businessmen for both short-range predictions and long-range projections is huge since they lie behind and support decision-making. Decision-making—deciding—is the biggest, if not the sole, function of businessmen. It is composed of many important components: recognition of the problem, fact-finding, statistical analysis, research interpretation, reasoning, considering alternatives, communicating ideas, understanding corporate aims and personal relations, and many others depending upon how one classifies them. Statistics, analysis, interpretation and economic philosophy, however, are the fundamental essentials lying behind studied decisions.

Now let me make clear that there is nothing necessarily inherent in the study of economics or accounting that makes economists or accountants forecasters. In fact, Professor John Jewkes in *Lloyd's Bank Review of London* in April, 1953, in attacking this problem said: "It cannot be too strongly emphasized that there is nothing in economic science which enables us to foretell events. Those who claim otherwise are dragging their subject down to the level of astrology. . . . There is nothing in history to suggest that the expected will normally happen. . . . Economic prediction as a scientific method is not merely absurd, because impossible, but dangerous, because seductive."

Recognizing the nature of this type of criticism is essential to every accountant and economist who would help his business executive colleague to make decisions. He can be helpful, I would argue, by making conditional forecasts and projections. Commenting on this same point in "Economists vs. Astrologers" in *Newsweek* in September, 1953, economist Henry Hazlitt said: "An honest business forecaster will, however, make all his forecasts frankly conditional, and merely probable. He is entitled to say: 'If X, then probably Y'."

As accountants and economists, we face another basic problem. We tend to be historians. We are almost continuously preparing and studying the record of the past. True, such records provide essential parts of the foundation for short-, medium- and long-term projections. Increasing thought must be given, however, as aids in decision-making, to the records not yet developed which will be necessary to interpret what lies ahead, almost irrespective, at times, of strict historical comparability.

To limit our market a bit and to throw this last point into sharper focus, for our purposes today I want to define "forecasts" as *long-term projections* in the range of 15 to 25 years. I would like also to consider the rather broad area of projections which relate to the economy and economics than to specific business data or general statistics.

II

For long range planning I shall use the term *projection*. It probably is not necessary to say anything about the importance of long-range planning, but two recent statements in this respect may be interesting.

In the Foreword by the Overall Panel to Special Studies Report II of the Rockefeller Brothers Fund, published in January, 1958, is the following statement:

> "As the twentieth century nears the end of its sixth decade, America faces a world in swift and often turbulent change. Both within our borders and beyond, enormous transformations—in human aspirations, in the structure of society, in economic development, in scientific knowledge—are reshaping the pattern of existence at a speed without parallel in history. The recurrent shock of our age is the discovery that concepts and patterns of action of a more secure past no longer fit the present reality.
>
> "We live in a period which insists continually on choices being made. But choice without purpose leads to paralysis or to fitful and erratic behavior. And power without a sense of direction may drain life of meaning if it does not destroy humanity altogether. Our problems, therefore, require for their solution not only great

effort and skill, but even more importantly steadfast conviction. And our opportunities will reflect above all the boldness and vision with which we face the future."

This statement certainly lays the general foundation for and indicates the importance of looking a long way ahead. For another opinion, in his "New Frontiers for Professional Managers," Ralph J. Cordiner, President of General Electric Company, has indicated that there are three frontier areas. He says:

> "Looking at business and finance broadly, with emphasis on the large organizations that are the subject of study . . . it would appear that the most urgent challenges to managers in the coming decade will lie in three relatively unexplored areas. First, the area of long-range planning. . . . Second, the area of organizing, communicating, and utilizing information for decision-making. . . . Third, the bafflling area of human motivations."

Projection is a relatively new word in the context of forecasts. It is usually associated with longer range outlook descriptions. Projections at times, therefore, may have some of the characteristics of prophecy. In current use, however, they are usually based on stated assumptions; they are prepared by the use of specifically defined statistical and mathematical procedures, and increasingly are the result of "models" of reasoning which can be programmed for electronic computers. I shall use the term in these latter senses.

For illustration I will use three types of projection techniques which I have found to be helpful aids in decision-making. The first will have to do with our basic economic philosophy; the second will deal with a general trend; and the third will provide a specific problem for industry.

Businessmen in the United States usually picture themselves as participants in a competitive economy. We have traditionally claimed to follow the classical or neo-classical philosophy. That this is true is made clear by our ready reference to "supply and demand" as being a major determinant of the supply of an item put upon the market or the price which results; the claim that prices are the forces which allocate resources to various uses; the belief that each economic resource will receive a share of the return from production in proportion to the demand for and supply of it; the belief that businessmen are rational economic beings who entei business to maximize profits; the understanding that nothing is free—that work, waiting or some other form of sacrifice by someone is required for everything; etc. We could extend this list, but these are some of the major precepts. These conditions may be approximately accurate descriptions for the periods of Adam Smith, John Stuart Mill or Alfred Marshall. I am sure they are not entirely accurate today for United States businessmen.

What agriculturist (including Secretary Benson) wants to depend on supply and demand to settle anything for agriculture? Certainly Senator Kefauver and his staff as well as businessmen and economists who have recently appeared before Congressional committees do not believe that prices serve the purposes assigned to them by classical theory. And there does seem to be an increasingly widely held belief that somehow or other it is possible to get things without work, or, shall I say, for someone else's work.

Certainly it does not appear safe to base any short- or long-term projection on the continuation of these classical economic theory precepts. Specifically for you accountants, what is the meaning of profit that you will use for your plans in the future? Now try to measure it.

In recent years we have had Keynesian explanations and interpretations added to our classical backgrounds. Challenges as well as confusion, if not frustration, have resulted for our decision-makers in business and in government. Keynes brilliantly succeeded in convincing a large portion of our economists of the validity of his depression-era developed theory that government must assume more responsibility as countries grow richer and more productive. Such countries develop chronic demand deficiencies which will gradually get larger. The solution to this problem the theory suggests lies largely in the governments' providing for a wider distribution of income and for spending larger amounts on government projects. If these bases for a new economic theory are right, then the general projections for our long-term future will be different than under assumptions of the classical theory.

But now, widely known and respected Economist Sumner Slichter ("The Passing of Keynesian Economics," by Sumner H. Slichter in *The Atlantic Monthly*, November 1957, pp. 141-146) says: "Keynes's theory has turned out to have been wrong in all its essentials." He says, "Advanced economies do not suffer from a chronic deficiency of demand—they suffer from a chronic *excess* of demand. It would be hard today to find an advanced economy that is not struggling to control demand, and most of them are having only partial success." Slichter believes that consumers play an active role in the economy (not relatively passive as Keynes assumes) and that because of the growth of the "Industry of Discovery," invention and product development, private industry has a great appetite for investment and capital.

Your choice of one or the other of these philosophies will markedly affect the projections you will make in such important areas of accountants' responsibilities as capital rates and costs, timing of investments, obsolescence, depreciation, taxes, costs, prices, etc. Although your long-term forecasts will be provided as reasonable ranges, you will certainly be no help in decision-making if your range is from the lowest figure under the Keynes assumption to the highest under that of Slichter, or vice-versa. In any case you must state your assumptions.

Now let us look more specifically at some of the kinds of problems which arise when we look at a basic long-term trend. For the last two-thirds of the 19th century our economy experienced a long-term downward trend in prices. Our grandfathers had adjusted their thinking and economic behaviour to this fact. They had always, except for short periods, paid debts with more valuable dollars than they incurred them. They therefore saved before they bought—in both their household and business affairs. In the early 1890's, however, there was a change. Since then the long-term price trend has been upward.

If we were to act in customary fashion we might simply expect a continuation of the existing trend. For the purposes of a sounder long-range projection, should we simply expect a continuation of the past, or should we examine the most likely prospect? We must do the latter—we must appraise the alternatives in this process.

We can start with a series of assumptions and assess their likelihood as we proceed. To do this let us ask the following questions—and develop our assumptions from the answers. Is it more or less likely that:

1. We will try to maintain our national policy of full employment?
2. We will continue to have free collective bargaining?
3. We will have fairly stable prices?
4. The rate of increase in wage costs will exceed the rate of increase in productivity?
5. The power of labor unions in bargaining will stay the same or increase?

For illustration I will use my answers to these questions. I think it is most likely that: (1) we will try to maintain full employment; (2) we will continue to have free (so-called) collective bargaining; (3) we will not have stable prices; (4) wage rate increases will outrun the rate of productivity increase; and (5) the power of labor unions in bargaining will stay about the same for the foreseeable future (it cannot increase much beyond its present level without a continuous recession threat).

It should be clear that a "yes" to the first three questions is incompatible. I have chosen to answer question (3) with a "no" so my combination of answers to these questions indicates that we are likely to have a rising-inflationary-price trend ahead of us. The rate of rise will depend upon the extent of the strength of the various forces involved, not only upon each of the three corners of "The Uneasy Triangle," to take a phrase from the 1952 issues of *The Economist* (London), but also upon the many other forces whose effects may be measured. My answers to questions (4) and (5) tend to strengthen the basic conclusion. The range of the rates of price increase can be determined by estimating each of the contributory forces and combining them in appropriate estimating equations.

In the face of such an assumption then, I can ask you, "What is the most likely or best agenda for this coming age of inflation?" And what will its implications be for us as accountants, planners for new data collections and interpreters for decision-makers?

Let me mention some of the major items for the agenda of considerations in the next quarter century:

1. War and the cold war with the necessary preparations for national defense, peaceful applications of atomic energy, jet travel and propulsion of satellites, etc. Expenditures for such purposes alone, whether by the government or the private sector, will probably be of such magnitude to cause price increases.
2. The continued growth and strengthening of trade unions will most certainly result in acceding to claims for higher wages and other employee benefits which will strengthen the cost-price spiral.
3. Our national policy of full employment will be continued and will probably be associated with increases in amounts and periods of unemployment compensation or guaranteed wages. These pressures are inflationary.
4. Gradually cheapening money to accommodate extended government programs will add to the inflationary impetus.
5. The gradual provision of more numerous and more generous social services by the government such as the current demand for more medical and hospital care for all ages, especially the older groups, will have inflationary effects.
6. Price controls either in terms of maximums allowable or minimum supports is likely in a period of expanding demands to develop pressures on supplies. These effects tend to be inflationary.
7. The likelihood of increased nationalism with protection of trade

for individual countries or groups of countries (as in the case of the European Common Market) in spite of all the efforts being made to establish trade on a widespread multilateral basis. The effects are inflationary.

8. The increased industrialization of undeveloped or non-industrialized nations is also inflationary.

There are many additional considerations that will support the thesis of continued inflation. (See "Agenda for the Age of Inflation" in *The Economist* (London) issues of August 18, 25, September 1 and September 8, 1951.) These are certainly sufficient to indicate some of the problems that will face accountants.

If there were a strong case for a period of declining prices, an equally long list of changes in accounting principles and practices would be essential to provide decision-makers with improved guides and tools.

Now let me give you some statistical projections which illustrate more clearly how ranges of estimate can be used to take account of forecasting uncertainties and statistical error. These projections we believe are basic for the farm equipment industry and for other industries which expect to sell to farmers.

The United States population whose demand for food and fiber is the basic although indirect demand force in our industry currently totals about 174 million. By 1975 we expect the total to range from 210 to 230 million and are taking the mid-point of 220 million as the most likely estimate. This growth represents a substantial increase in the demand for farm products. To meet this need farmers will require more and better farm machinery.

By contrast, the farm population is declining. From the current estimate of about 20.5 million we expect the total by 1975 to fall between 13.5 and 17 million. This will represent about 7 per cent of the total population compared with the present 13 per cent.

Agricultural employment like the farm population is declining. Total employment on farms, currently estimated at approximately 7.6 million hired and family workers, by 1975 will probably decline to 4.5 to 6 million, a decrease of nearly one-third of our present total. There will probably be little if any further decline in the proportion of hired workers. Most of the decline will therefore come from family workers.

The acreage used for cropland in the United States has been nearly stable at about 400 million acres since 1920. This total will not change much by 1975 but we are estimating that it will increase some 4 to 10 per cent to bring the total to 415 to 450 million acres. However, these will not be the same acres we are now using. Substantial acreage adjacent to large cities and on grades which will be taken by highway construction will disappear from their cropland uses. Lands now in pasture, woodland or wasteland will be improved and brought into productive cropland to replace that used for more direct human use. The greatly increased quantities of foods and fibers required by our larger population will therefore come from essentially the same total number of acres we have been using for the purpose since 1920.

The number of farms on which our agricultural products have been grown has been declining steadily from 6.8 million according to the Census of 1935 to 4.8 million at the beginning of 1955. We expect this total to continue to decline and are estimating that by 1975 there will be 3.2 to 3.8 million farms in the United States. Changes in definition of a farm are of course very significant in appraising these changes.

The average size of these farms will continue to increase. There has been a steady and almost uninterrupted growth in the average size of farms since 1880 when the Census indicated an average of 134 acres per farm. The 1955 Census showed 242 acres. By 1975 the average may be as large as 350 acres with 325 acres the most likely size.

Of most significance in measuring our markets is the number of farms by size and value of product. The most productive farms in the country and those accounting for the largest percentage of the total value of agricultural products sold are those which are 180 acres or larger in size. In 1920 such farms accounted for less than 20 per cent of the total. By 1975 there should be 1.3 to 1.4 million of these farms out of the total of 3.2 and 3.8 million.

Between 1920 and 1955 the man-hours of labor used for farm work declined by about one-third. For work in connection with crops the decline has been substantially larger—50 per cent; the decline related to livestock has been about 18 per cent. By 1975 the man-hours will decline substantially more—by as much as 30 to 45 per cent.

Cash receipts from farm marketings plus government payments in 1957 which basically must sustain all of the increases in investments made on farms totaled about $31 billion. We expect cash receipts to continue to increase in current dollars so that by 1975 they will total $38.6 to $41.0 billion.

Since the number of farms is declining as much as I indicated earlier, the cash income per farm will increase very substantially. Our figures show an average of $7,400 per farm in 1955. By 1975 cash receipts per farm should total between $13,500 and $15,000 per farm taking account of all large and small farms.

The foregoing projections have been made by extrapolating trends of historical data in most cases. In some instances the extension of trends was impossible, for such extensions would have reached zero long before 1975. As a result some of our trends are rationalized computations. To make them useful for any one aspect of a given business, they would have to be further refined to take account of the particular portions of farming dedicated to one or another or combinations of crops, their locations in the different sections of the United States and of their size and income.

Time does not permit illustrating this for you. I have given you enough information, however, to support an important general conclusion. The total number of farm customers is declining steadily; the total amount of production required of our farms is increasing; the total cash receipts available for farmers' purchases of equipment and supplies is rising steadily and the supply of labor is declining. The farm market for capital equipment therefore should be a good one.

III

Detail must now be added to each of the foregoing projections or to combinations of them to make them useful to each decision-making executive. For the finance officer I would combine the three with great emphasis on the first two. A different combination of projections and substantial modification of supporting detail would be essential in interpreting for the sales department the effects of anticipated changes on product development, sales programs or salesman training. The accountant, of course, like the economist, may have to work with the broadest ranges of details with all such projections.

For you a new and fresh look must continually be taken at established definitions and procedures if you are to be of maximum assistance in decision-making. To mention a few such areas might be helpful. You will have to pay special attention to utilization versus obsolescence and depreciation of capital. You ought to be aware of the weaknesses of customary differences in accounting for capital and manpower costs in research. Greatly improved methods of inventory appraisals and control must be developed. Better understanding of the effects of scheduled periodic escalation of costs on prices such as wages through cost-of-living and productivity increase factors must be expected. Programs involving employment stabilization, inventory controls, production scheduling (including economic lot sizes) and sales forecasting will require broader understanding of records systems and the timing and clarity of communications.

Understanding of the economics of our social programs will be as essential as participation in guiding many of them through membership on boards of hospitals, colleges, etc., in order to see that they too operate on economic principles appropriate to their purposes. Time keeps me from going further.

Upon you, as successful accountants and comptrollers, will fall the responsibility of the several levels of interpretation needed for improving the decision-making procedures. In the words of Glenn Frank:

> "The future of America is in the hands of two men—the investigator and the interpreter. We shall never lack for the administrator, the third man needed to complete this trinity of social servants. And we have an ample supply of investigators, but there is a shortage of readable and responsible interpreters, men who can effectively play mediator between specialist and layman."

MARKETING RESEARCH—VITAL ADVANCE PLANNING TOOL

By Thomas G. MacGowan
Director of Advance Planning
The Firestone Tire & Rubber Co., Akron, Ohio

Emphasis on the long-range or advance planning functions of business in your program at this meeting is testimony to the alertness of your program committee in keeping abreast of business developments—in this case, of what is perhaps the most striking and clear-cut development which has taken place in business since World War II.

The emergence of planning—advance, future, long-range—as a major preoccupation of the more progressive business leaders of this country certainly is a most interesting phenomenon of the present day.

Today perhaps 50 per cent of the really large businesses, including not only manufacturing but also finance, retailing, transportation and other communication, and mining, have set up some sort of organizational feature which is intended to make sure that the business will make adequate preparation for the future.

Most of those which have not yet taken that step are thinking about it. Some of them are sending men around to interview planning executives in other companies to get ideas on the best way to go about the move themselves.

Before discussing the role which marketing research plays in corporate planning activities, it may be well to look briefly at the planning function itself.

What is advance planning? What is it *not*? What functions does it customarily discharge? How do companies as a rule organize for it? Whom do they put in charge of it? To whom does he report?

Having answered these questions we shall try to show how marketing research fits in, and how, without it, the advance planning activity would surely fail.

First of all, advance planning (that seems to be the term to which most planning-minded concerns are gravitating, rather than to the possibly more descriptive long-range planning) is simply making plans for the future of the business. Obviously, moreover, the activity exists to make the concern's future better than it would be if the activity did not take place.

In some concerns there is a tendency for the planning head to concern himself, either of his own volition or on the suggestion of his superior, with matters which, while in the future, are rather near at hand. This is a great mistake—advance planning should not concern itself with tomorrow, or next month, or, probably, six months from now.

Conversely, it should concern itself tremendously with where the company will be 10 or 20 years from now. It should certainly be interested in the position five, three and two years from now. And if it could do its part to bring about a good future for the business in terms of those periods only by working on affairs that will transpire next year, then by all means it should do so.

The planning activity should, it seems to me—and in this I am in agreement with most planning directors—first of all undertake to see where the business is heading. Is it in a line or lines which have a good outlook? Fifty years ago the planning director of a buggy business (if there had been such a position) should have seen the shadow of the automobile athwart his company's path some years previously, and he should have been working out plans for his company to change in some appropriate way with the changing times.

Are the principal products of the company—while in lines which overall have a good future—themselves individually likely to fall behind the procession? Twenty years ago the planning director of a maker of more-or-less conventional washing machines should have been pointing out to his principals not only the forthcoming rise of the automatic washer (and perhaps also the home drier) but he should have been working on plans for his company to cope with these developments.

Is the company sufficiently diversified? Diversification is not just a modern business fetish. It has a sound basis in hard-headed and shrewd business sense in a great many cases. It not only affords a means of growth but it also spreads over a business a protecting umbrella of variety. Did the business fall on its face when it came to getting in the field with an automatic washer? Did it stay too long with the buggy business? Such things have been known to happen despite the best efforts of astute managers and well-intentioned staff people. And many such concerns have been able to stay afloat because they had stakes in other kinds of business not then affected by unforeseen and unwelcome change.

Are the company's channels of distribution already undergoing important changes, or are such changes in the future but discernible by a clear-eyed look down the road ahead? Did the food manufacturers of 1927 realize the extent to which the mushrooming supermarket movement would affect their business? How many of the great grocery chains which were then primarily doing business in small conventional-type outlets realized that they must before too long become super-market merchandisers or lose their business? Moving ahead a few years, how many of the manufacturers of proprietary drug specialties and cosmetic items foresaw the impact of the great grocery supermarket chains upon their established distribution channels?

The answer of course is that some food manufacturers, some food chains and some drug makers did see these things coming and that some did not. Some were well-prepared and some were ill-prepared. So it has always been in business, and no doubt so it will always be, even though today the presence of a growing group of people whose sole business it is to think about the future will inevitably tend to mitigate the impact of the unforeseen.

Well, if the company's chief product is in a declining phase, what should we make now? If the product is changing, how should our version of it change? If the channels are about to undergo some important alteration, what should we do about the situation?

The planning director must function on these matters in his role of bird dog (to find new products and new product development ideas), fact-finder (to learn what the available alternatives may be, and the pros and cons of each) and analyst (to weight the possibilities as a prelude to recommendation to his management). He must also function—in the usual situation at least—as a sort of combination stimulator, catalyst and coordinator. Obviously he cannot as a staff person do all the company's planning; it would not be desirable to have him do this work for the various parts of the business involved even if he had the time, manpower and talent to do it. People operate best with plans which they have had a strong hand in developing.

But he must "work with" the people who are in charge of the various parts of the business. I repeat: he must stimulate, catalyze and coordinate. To the executive whose division is giving signs of staying too long with a losing hand in the product development race he must bring new ideas and some good practical suggestions, as well as a healthy sense of the necessity for some real action. To the management itself, which has been for some time considering a possible new product or a new course of action of any important type, he can serve as a catalytic agent by bringing to their attention new evidence, new thoughts or sometimes simply by pressing tactfully for action or decisions. When a new product or a new undertaking of any sort is in the making he can often tie things together by serving as a departmental or personal link between the many diverse departments and personalities which must work together as a team if the thing is to be successfully brought to reality.

This planner of ours often negotiates with other companies which are for sale, which have patents or processes to which manufacturing or selling rights are available, or which may constitute a market for the company's own products. But as a rule his activities as an actual *operator* do not go beyond such preliminary or preparatory moves.

He is not a person who actually develops the new product; in other words: that is for the XYZ division to do. He may get the company into a new business and assist in setting up a new division to handle that business, but he will not run that new division. He will make no plans for the business which has to get new channels of distribution; that is their job. He will point out the trends, get facts, work with them. But the plans will be theirs. What he will also do is to have in view at all times *the big picture* for his concern: he will know where the outfit is going, and whether it is going on the basis of the present plans to have a satisfactory future or not. And if it is not, he is going to be in there with the necessary forecasts and predictions for the management, and with suggestions as to what should be done about them.

It surely is obvious that a planning director cannot operate along the lines I have indicated unless a number of situations hold good. Here are what I call the minimum essentials for satisfactory functioning along this line: (1) the director must have the requisite talent, experience in and out of the organization, and he must be properly set up; (2) as to set-up he must report directly to the top management, have enough status to make him effective within the organization, and have enough people to do the job properly; and (3) the management must take him into their confidence to a reasonable extent.

As to this last point what I mean is that a management can hardly expect a planner to know whether the existing plans are good enough or not if they do not let him know what they are intending to do. In particular he has to know what the company's capital expenditure budget looks like for the future.

Most planners today are directly a part of the management, at least in a certain sense. Sometimes the responsibility is entrusted to an "assistant to the president", or to the "executive vice president", or to a "vice president in charge of the future." But regardless of titles, here is the fact. If such a person has other heavy responsibilities he cannot do this. If he is already busy, then the man I have been talking about—the man who will actually do the job—will be somebody who works for him without benefit, perhaps, of portfolio. This is not too bad an idea, in fact, and often it works well.

The more usual thing, of course, is a part of the organization consisting of a planning director, manager or head, and some sort of a staff. This group does the things I have been discussing, and it usually reports to the president or executive vice-president of the business.

And just who *is* the person who heads up this planning activity? He is in most cases the person who just previously held the post of director of manager of marketing research. In the great majority of the cases he has also been with the company long enough to know it and its problems and its personnel very well indeed.

Why is marketing research experience in that company usually esteemed as the right background for the planning job? Basically it is for two reasons. First, the kind of person who has done marketing research work successfully has the know-how and type of mind needed to solve the problems of the planning end of the business. Business planning calls for the same kind of curious, probing, skeptical, analytical approach that the study of markets and marketing processes also requires. And, second, the planning job also calls for the doing of a great deal of marketing research work, and this can best be arranged for by someone who has a full understanding of the marketing research process.

Does this mean, then, that the advance planning director should also *be* the marketing research director? Not necessarily. In fact, in a larger company this would be a sheer impossibility. I have already pointed out the fact that the planning activity is a full-time thing in itself.

But in many medium-sized and smaller companies the two jobs can be and sometimes are combined. In others—and this also goes for some of the larger concerns which have not yet formalized the planning function, a great part of the marketing research manager's work is of tremendous service in planning the future of the business. There are in fact many instances in which the marketing research head gradually *grew* into the advance planning role. In such cases what seems usually to have happened is that the individual in question increasingly concerned himself with matters of the long-range future, more and more presented to his management forecasts of a comprehensive and long-range nature, and increasingly concerned himself with studies and analyses which dealt with new products, better distribution methods and other changes which would in the future tend to maximize sales, improve company stability and make for greater profits and more security over the long pull.

After a certain length of time, such a man's orientation of himself and his department toward the future has often been followed by the management's decision to make his planning responsibilities more clear-cut and overt. What then happens is that he becomes the planning director. Does he then retain the marketing research activity as a subordinated responsibility, with the new marketing research manager reporting to him? Yes, in many cases that is the course which is followed. It may seem desirable for a variety of reasons, two of which might be the advisability of retaining his experience in connection with over-all direction of a marketing research program, and making sure that marketing research would continue to play its full and proper role in advance planning.

In other cases it is not considered desirable to retain a direct organizational link between planning and marketing research. But whether such a link exists or not, the advance planning man cannot possibly function without a great deal of marketing research work by him, or done in his behalf.

In a moment I am going to describe some of the types of marketing research work which are essential to planning success. But first I would like to digress just a bit to explain something that may seem a little inconsistent in what I have just said. It will be remembered, I am sure, that during World War II a great many companies set up what were often called "post-war planning committees", and in a great many cases the chairman of this committee was the manager of marketing research. Usually his department would perform the marketing studies required by the committee. In such instances the planning and the research functions were actually performed under the immediate direction of the same individual. Why so, when today the larger companies sometimes have the marketing research manager report to the advance planning man, but seldom actually unite the two jobs?

The answer lies in the fact that the wartime planning job was temporary, and that it would not have paid to set up a permanent organization to handle it. Today planning is considered as a continuing, rather than an emergency function. Parenthetically, it is interesting that some of the men who combined the marketing research and post-war planning jobs during World War II are today on the planning job again, with or without a marketing research manager reporting to them, as the case may be.

I stated earlier that the first thing for an advance planner to do is to figure out where his company is going to be at some fairly remote future point, and in the intervening years as well. This is obviously a matter of forecasting, and forecasting is in turn a job for marketing researchers or others with equal skills.

Does the previously enunciated principle about having people make their own plans carry over here? Are people better off to make their own forecasts? Should the XYZ division make its own forecasts for the years 1960, 1965, and 1970? (Forecasts to 1975 are, by the way, by no means uncommon.) Or should "experts" make them? The answer of course is that experts should make them, but that the experts need not be in a centralized marketing research department. Many companies are so thoroughly decentralized as to marketing research that there may be extremely competent forecasting people in the various manufacturing or marketing divisions. If there are, then by all means these people should make the first forecasts. Indeed, even if such people are not to be found in the divisions, the forecasts have to be made for the most part in the divisions anyway. Forecasts cannot be made successfully in the large; they have to be built up like a masonry building, stone by stone. No remote group of marketing people could possibly have the necessary familiarity with the individual lines and products of the XYZ division to make an acceptable long-range forecast of where they would go individually and in the aggregate.

But if the XYZ division lacks marketing research personnel, and if, as a result, its forecast has to be prepared by others, where will the marketing research talent be brought to bear? By means of a centralized marketing research department's performing a reviewing function after the fact? Possibly, but preferably such a department should work with the division in question at the time of the forecast, supplying general counsel and guidance as needed. If this were done, the review which took place later would, in the event of the inevitable suggestions for change, be accepted with much better grace than if there had been no prior contact on the matter.

These forecasts of which I have been speaking are the kind that reflect what will happen if the company does not do anything different from what it now intends to do. They are finally all added up to get the company's over-all future prospects, including as a rule some sort of an item representing the planning director's best idea as to what new products might find their way into the picture outside of the existing divisions but in furtherance of plans already under way at the corporate level.

Without exception company total prospects developed in this way are bitterly unsatisfactory at first glance. And when they are compared with forecasts of various general measures of economic growth which the company may prepare or have access to it often turns out that the company looks as if it would be falling behind. Finally, when they are compared with purely mechanical extrapolations or projections of the company's sales from the known sales of the past, the contrast becomes pretty devastating.

However, it is natural that forecasts based on making no new plans would be too low. New plans would be made even without an advance planning activity. Therefore such forecasts never work out. Nor are they ever expected to, for they are merely a first step, as I said before. They are followed by a formalizing of the planning process, in the course of which each part of the business commits itself to a growth goal which could be achieved only by vigorous, imaginative and resourceful planning and development.

In achieving the goals marketing research also plays a vital role. Will the new line of fertilizer find a proper place in a market full of both dry and liquid fertilizers? Will its combination of performance, form and price prove attractive? Could we get proper distribution of it? What would be the best channels? How much would we have to invest in the business? How rapid would be the payout, based on the probable levels of sales, gross margin and expenses? Is this the best way for us to make an investment of this size at this particular time? Finally, how great is the risk involved? Is the risk too great? How does it compare with the risk of possibly losing marketing position by *not* bringing out the product? How does it compare with the risk which would be involved in producing various other products in this or other divisions of the business?

The extent to which marketing research would be expected to assist in supplying the answers to these questions, and hence to answering the main question: "Should we make the product?" depends primarily upon how much is already known about the market, its composition as to customers, product and channels, and about its historical acceptance or rejection of new offerings of this general type.

If the company's experience has been such, in this particular area, that a great deal is already known about these matters, then the marketing research contribution will be somewhat minimized. But it will still be necessary for information to be checked and up-dated, and for judgments to be made as to the probable extent and speed of the product's market penetration, the proper channels and their probable reactions, the impact of various pricing and discount policies, and, finally, the probable level of sales for each of several key years in both units and dollar volume.

This example serves as a good medium for explaining the extent to which an advance planning operation must necessarily depend on other departments of the business than marketing research. The engineering department would be called on for estimates of the cost of plant and equipment, and judgments as to how much time would be required for their installation. The research and development department would already have developed the product and supplied information as to its performance characteristics. The cost accounting department would have prepared the estimates of unit costs and over-all dollar gross margin at various hypothetical production levels. Estimates of expenses might be contributed by the traffic department (as to transportation cost), the labor or industrial relations department (cost and availability of labor at the plant site), the sales and advertising departments (as to the cost of distribution), and so forth. It is also probable that the comptroller's department of the business would in the case of a product or line involving a very large outlay for plant and equipment also make an estimate of the amount of working capital required for payroll, inventory of various types, and accounts receivable.

Out of all these efforts there would emerge a coordinated picture drawn together by the advance planning division in the case of a wholly new type of product which would require a separate manufacturing and selling set-up new to the company. In the case of a product that would be made by an established part of the business, the advance planning people might only cooperate in the pulling together of the picture. Or they might have supplied merely the initial spark that got the thing started. If the advance planning people were on the job it is inconceivable that they would have had no part in studying any important new product.

It is equally evident that in the case of such a product the marketing research talents of the business would have been called on in various ways in the effort to reach an answer to the primary question: "Shall we make it?"

Once that decision was reached, marketing research services would be required also in further work in laying out the proper methods of initial introduction. How much should we spend on advertising, for example, and in what media? Advance planning might in its role of catalyst make sure that this research actually got done.

One very valuable type of marketing research work of much use in advance planning is the comprehensive survey of many fields of manufacture or distribution in which the company might engage. Let us say that the best projections of the sales of future years show strongly that the company is going to have to do some things not now contemplated or planned, or resign itself to an unsatisfactorily small volume in future years It appears that the company's present lines of manufacture do not hold enough promise for future growth, even with a properly aggressive policy of new product development. Clearly there is needed a very basic type of review of a number of other fields, new to the company in which it might profitably engage.

Here we have a sort of investigation in which marketing research work or its equivalent by another name is called for. The fields under investigation have to be looked at in various ways, and some of these ways call for the gathering together of market facts, and evaluating them. Yet there is also a good deal of work of other kinds involved, and in this the talents of non-marketing researchers will be needed. The best thing is usually for the advance planning people to entrust the marketing research aspects to the marketing research department. Actually, however, this in many cases is not done.

It is not uncommon for the advance planning people themselves to make the marketing research investigations in some of these very basic yet exploratory studies. In this way they can sometimes combine such work with investigation of other aspects of the study, while in the field.

Similarly, advance planning work intended to solve the ever-troublesome and often-recurring problem of whether to "make or buy" a certain product or component of a product usually involves some marketing research work, but the planning people sometimes find it advisable to do this themselves. It will be recalled that the planning director is usually a man with a marketing research background; his key people have often had experience of that kind also.

Once the decision to enter a new field has been made the question frequently arises: "Should we start from scratch or buy a going concern?" Many matters are involved in a decision of this kind, and of course one of the key factors is what going concerns there may be available. This in turn frequently involves a company search. Marketing researchers are sometimes involved in such searches. More commonly they are called in to appraise the marketing structure of the individual company under consideration. Their conclusions are invaluable in the work of the planners.

Beyond the areas which I have mentioned, there are a tremendous number of specialized types of marketing research which may be needed and called for in connection with the work of planning a prosperous and secure future for a business. Merchandising research, study of better methods to locate retail outlets, analytical study of troublesome problems of retail store management and of dealer relations, pricing analyses, basic studies of consumer motivation leading to development of better advertising themes, basic media research pointing to better distribution of a company's advertising investments media-wise, packaging analysis, fundamental studies into territorial alignments and personnel policies, including the selection, compensation, direction and performance evaluation of salesmen—these are a few of the many types of marketing study which bear on the work of the conscientious planner in a large business enterprise.

Advance planning as such is new. Marketing research is not so old itself, as business institutions go, but by comparison it is very old indeed. Just as advance planning, the fledgling, sprang from the nest of marketing research, it will for a long time to come depend upon it for personnel and for a great deal of work. These two fact-oriented disciplines have much in common with each other, just as they do with the various areas within the accounting field, including yours.

Indeed, the time will never come when the facets of a well-run business do not make joint contributions to the study of the future and to new ventures. The partnership of advance planning and marketing research in which the former draws upon and often guides the latter, is a liaison based upon need. As such it is—if I may venture the sort of look into the future which both marketing researchers and planners often have to make—a relationship which will be likely to continue for a very long time.

PROFIT PLANNING

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The term "profit planning" is a relatively new term. It is only within the last 5 or 10 years that it has appeared to any extent in accounting literature. But in this relatively short space of time its use has become quite popular and like so much of our terminology it has come to mean different things to different people. It is apparent in accounting literature that to some, profit planning is closely related to cost-profit-volume relationships; to others, the term is synonymous to "budgeting"; to others, it is closely allied to "cost reduction." Upon reflection, it is apparent that the term might well be used to encompass the total responsibility of the accountant, for certainly the achievement of profits is the ultimate objective of any and all accountants.

Mr. Eric Kohler, in the second edition of the *Dictionary For Accountants,* defines profit planning as "the process of so conducting operations as to realize a given profit goal." This does not limit the concept of profit planning to any one aspect of the accountant's sphere of activities, but relates profit planning to the entire area of the conduct of operations. The element in this definition which interests me the most is in the phrase "given profit goal." This implies that a goal has been determined, presumably a goal which is reasonably attainable. Surprisingly enough, it is getting people to admit to a goal which is oftentimes the most difficult aspect of profit planning. This difficulty is not necessarily limited to the non-accounting members of the managerial team, for many times it is accountants who take the path of least resistance and claim that planning, in their firms, simply cannot be done.

The two previous speakers this afternoon have presented very illuminating discussions of two important tools of profit planning, namely economic forecasting and market analysis. Both of these are important ingredients of profit planning, but they are not ingredients which the accountant is necessarily responsible for developing. Given these and other tools, it is the duty of the accountant to formulate them into an operating plan. Motivating the accountant to do this is oftentimes difficult.

The two previous speakers this afternoon, disclaiming to be accountants, very graciously extended some complimentary remarks to the accounting profession. Being an accountant myself, I am neither entitled, nor am I so disposed as to extend a great many compliments to the profession. Due largely to an unusual language, which is peculiar to the art, accounting was a field which has been little understood by non-accountants. It is human nature to hold in some awe anything which is not completely understood. So it has been with most non-accountants who view our art. A large segment of the accounting profession has been willing to enjoy the fear and respect of non-accountants, while doing little to advance vigorously the contributions which accounting is capable of making.

In support of this view, let me quote what one accountant had to say in a recent addition of the NAA Bulletin:

> "As accountants, we have not prepared ourselves or our employees for the advent of the revolution represented by the inroads which operation research, with electronic data processing, is making in the industrial accounting field. These new methodologies are demanding personnel with a background startingly different from those of us who have entered the accounting field during the past quarter century. Whereas a background of accounting and accounting studies was the prime prerequisite for employment in the accounting field during the past decade, the man with such a background as his sole "stock in trade" will disappear as rapidly from the American industrial scene as the "man in the green eyeshade" disappeared during the days of our predecessors. *The years immediately ahead will demand men with mathematics and engineering as a major field of study, and with business administration and accounting as a minor.*

In order for us to meet the demands involved, we must prepare ourselves and our employees through a serious program along the following lines:

1. We must become acquainted with the new methodologies by attending seminars and, if necessary and practicable, by a leave of absence from our present positions to attend special schools to learn the techniques of electronic data processing and operations research.
2. We must program on-the-job training to pass on to our employees the information we have gathered in these special classes.
3. We must start now to evaluate properly the capabilities of our employees and to program required alteration of staff skills "mix." The "doers" will be eliminated by the machines; we will need in the future the men who can tell us "why it happened," not "what happened."

4. We must revise our background requirements on new employees to include a basic knowledge of mathematics from algebra through integral calculus. *Too often our accounting employees, past and present, have been individuals who turned to the accounting field through failure to comprehend mathematics, odd as that may seem to some.* Such an employee will be "lost" in the new field.
5. We must think along the lines of employing also the man who possesses the mathematical, engineering and possibly shop experience, with no accounting background whatsoever. On-the-job training can supply all the accounting necessary.

The operations research and electronic data revolution is upon us. Let us honestly admit it and start now to prepare ourselves and our associates to meet its demands."[1]

While I have a great deal of respect for mathematicians and engineers, I am not yet willing to see accounting become a minor field to these.

The most important element in profit planning, as it is in any endeavor, is that of attitudes. The first thing which management, as well as accountants, must develop is the attitude that, although it may not be 100 per cent correct, a plan can and will be developed. In going into any organization where formal planning has never been done, one is invariably confronted with innumerable reasons to show why planning simply *cannot* be done in this particular organization. I have heard the response, "our situation is unique," more times than I can recount, and perhaps you have also. The easy way to avoid having to tackle difficult problems is simply to say "our situation is unique." It is not that I am challenging for one minute that these firms have unique situations. Of course they are unique. If all circumstances encountered in one firm were precisely like those encountered in all other firms, we would have no need for accountants—bookkeepers would be sufficient. There would be no problems, and it is in solving problems that our existence as accountants is justified.

Reference was made, a moment ago, to firms that had never had a formal plan. It is important to differentiate here between a "plan" and a "formal plan," for there is not an executive anywhere who does not have some kind of a plan. All too often, however, he is the only one in the organization who is aware of what the plan is, and even in his own mind the plan is oftentimes ill-defined and nebulous. The problem is to get him to admit that he has a plan, and then to refine it and make it known to others whose actions depend upon it.

[1] Raymond B. Jordan, "Changed Qualifications For Industrial Accountant," NAA Bulletin, April, 1958.

I have encountered a number of real obstinate cases where individuals would persist in the attitude that planning was absolutely impossible in their unique circumstances. In such cases, on a number of occasions, I have broken down the resistance by taking last year's income statement and simply asking the executive to give me his wildest guess as to what each item in the statement will be next year. Invariably this produces a series of reactions which are precisely the ones desired in order to initiate profit planning. Let us examine some typical ones. A common response will be "I can't estimate that item. If a given circumstance develops, it will likely go up, but on the other hand, if something else happens it will probably go down." At this point, obtain two sheets of paper and label one "alternative A" and the other "alternative B", making it clear that we have no reluctance to developing two plans: one for each of two eventualities. In the course of later planning, each of these alternatives may be examined more carefully to ascertain which of the two is really the most likely, and specific planning for this likelihood can proceed accordingly. In the meantime, however, the development of an alternative plan is not at all unsound.

Another common response is "I can't estimate that item, because that is someone else's responsibility." It may be the sales manager, the plant manager, or some other responsible executive. The obvious thing to do is to call in the individual to get the benefit of his thinking, and this again is the precise reaction which is desired. There are several principles of planning which are accomplished by this move. First, the person who is responsible for any item should always be consulted in planning for it. This is important, first, because he has the best acquaintance with the particular item, and therefore, is in the best position to anticipate its future behavior.

Furthermore, and possibly more important, the individual responsible should be consulted for psychological reasons. In fact, if at all possible, we should use the estimate which he himself makes. If someone else makes the estimate, particularly one who is less acquainted with the item than he is, he will almost certainly try to prove, by subsequent actions, that the estimate was wrong. If on the other hand, he makes the estimate, he will have his own reputation at stake in trying to prove that he was right.

A second important factor in profit planning is demonstrated in calling other individuals into the discussions. I am referring to what might simply be called communications. I am thoroughly convinced that one of the major road blocks that develop in a large organization in arriving at a satisfactory profit goal is in the lack of proper communications. Not only is there frequently a lack of common understanding of what the goal is, but even worse, frequently executives have opposing goals. This was brought out in one organization recently in profit planning discussions such as these. Most of this company's distribution had been accomplished through sales to independents. Some experimentation had recently been done in distributing through chains, but numerous difficulties had been encountered. In discussing next year's sales budget, it was apparent that the president of the company assumed that the chain store sales were to be pushed vigorously, while the sales manager had assumed that the experiments had proved this to be a fruitless endeavor, and was, therefore, planning to abandon the effort. By attempting to formulate an over-all company plan, this serious discrepancy in objectives was brought out. Without the exchange of ideas which are brought out through planning discussions, it is uncertain how long these two important executives would have been pursuing opposite objectives.

Much can be said about good communications, but to me the most important starting point is the development of a profit plan, based upon a full and free discussion of all executives involved.

If the initial resistance to profit planning can be overcome, skepticism will soon change into enthusiasm. In one company, where a meeting had been called to develop a profit plan for the first time, the resistance on the part of the top executives almost reached the point of cynicism. Finally, one of the group made some positive assertions with respect to his opinions of the future course of the company, and the debate was started. Within minutes, problems were being brought forward which otherwise would not have been considered until a crisis had developed. Before the sessions had been completed (which extended over a period of several weeks) numerous problems had been placed before the group—problems which otherwise might not have come to the attention of many of the top executives until lack of time would have prevented the development of a sane and sound solution.

In dealing with a variety of men in top managerial positions, I am sure you have all observed how some seem to lead a fairly stable sort of existence, while others seem to be living from one crisis to another. One executive friend of mine once stated that the only time he ever got to play golf, which was not very often, was when he found that he did not have a crisis confronting him. I wonder if anyone has ever developed a coefficient of correlation between the existence of crises and the lack of proper planning. I am confident that the degree of correlation would be high.

Organization As A Prerequisite to Planning.

Some recent experiences which I have had have illustrated rather dramatically the profound importance of proper organizational structure for effective profit planning and control. This is a concept which is frequently referred to in the literature, but one which has received far too little attention in practice. For one thing, organizational realignments are unpopular and, therefore, something we try to avoid, if at all possible. But as a result, many so-called organizations are a hodgepodge of illogical relationships, thinly held together by custom and prestige. In several studies conducted recently in large organizations, a number of fairly responsible officials reported that they did not know who their superior was. Still others, in response to a questionnaire, reported that they had several superiors. The latter situation can be particularly damaging from the standpoint of accounting control. One official, when questioned about a particular action which he had taken, indicated that he had been instructed to take this action by an individual who, according to the organizational chart, was not his supervisor. Many instances can be found in poorly organized firms, where, through many years of custom or other combinations of circumstances, individuals will be taking orders from persons who are in no way responsible and thus in the final analysis not accountable.

For proper planning and control, every action in an enterprise must be clearly the responsibility of one individual who in turn is responsible solely to one other person. Areas of authority must be clearly defined and lines of responsibility well established. Graphic representation of these relationships in an organizational chart is not sufficient. In addition, a carefully prepared manual is essential, clearly setting forth in descriptive fashion, each duty, responsibility and the types of actions which an individual is empowered to take. If staff relationships cut across line authority, an advisory nature of these relationships must be clearly established, leaving final responsibility through the line officials. Then, and only then, can sound planning be accomplished.

Other Elements of Profit Planning

Prof. James McCoy once observed that a profit plan would be well worth all of the time and effort which went into its preparation, even if after its preparation it were thrown in the wastebasket and never used. Although such a procedure is certainly not to be recommended, the moral of the illustration is well taken. The point is, of course, that profit planning forces executives to look forward and anticipate many of the problems which will confront them in the months and years ahead. It forces consideration and discussion of these problems, thereby enabling everyone concerned to be aware of them and permitting calm and careful consideration of possible solution. This, in and of itself, is important and worthwhile even if nothing further were done with the plan.

This procedure is of course, not to be recommended. For maximum benefits a good plan should be followed at each step of its unfolding with proper measures of actual performance in comparison to the plan. Such actual measurement provides motivation for those responsible to conform to the plan and also provides valuable experience for better profit planning in the future.

Some other techniques, better known among accountants, can and should be utilized in profit planning. One of these techniques is that of cost reduction. If the initial plan indicates an unsatisfactory profit or, perhaps, even a loss, it may indicate that certain costs are too high. Cost reduction methods represent an area with which accountants have considerable acquaintance. These methods involve such things as the use of standards, time and motion techniques, and variance analysis.

There is one area of cost, however, which has probably not received the attention which it deserves. In talking to executives in a wide variety of diversified activities, I am hearing increasing complaints about the way in which administrative costs are becoming exorbitant. One, perhaps, thinks immediately about the use of electronic and other types of machines as a means of reducing administrative costs. But I am wondering whether, in some cases at least, we have not experienced an excessive amount of this medicine. Another danger in this same area is to incur the additional cost of the machines under the guise of labor saving, without actually reducing labor costs at all. Indeed, I have witnessed a number of instances in which office payroll costs were considerably increased with the addition of machines. I am well aware, of course, that labor saving is not the only objective in the adoption of machine systems, but I am equally certain that many instances exist where reductions in office payroll have not been pursued with sufficient vigor after the installation of office machines.

Another important approach in the reduction of administrative costs, which has been receiving widespread attention recently, is through the elimination of records and reports. In many instances, it has been little short of astounding how many records and reports have been kept simply because some accountant felt that they should be maintained, rather than because careful analysis shows that they are useful in any way. Integrated data processing is another technique which is deservedly receiving current attention in the area of administrative cost reduction. The application of cost accounting techniques and those of standard cost accounting should be receiving far more attention than they are in the area of administrative cost reduction.

A very interesting technique in the area of administration cost reduction came to my attention only very recently. Referred to as "the quality control of paper work," it is an attempt to apply to certain administrative procedures the same techniques which have been applied to the quality control of production. Utilizing statistical procedure, this involves, first, the choosing of an appropriate sample. Control limits are then established for the degree of error which will be tolerated. Thereafter, tests are taken at the indicated intervals and the degree of error found in these tests is used to determine whether or not the entire production is within tolerable limits. Experiments are now being conducted with the application of these same techniques with certain administrative procedures, such as the checking and verification of invoices. A little imagination would undoubtedly suggest other areas of administrative procedures wherein these same techniques might be utilized. We may expect to see much more on this subject in the literature in years to come.

Another element in profit planning which was mentioned earlier is that of cost-profit-volume relationships. There are a number of things which come to mind with the mention of this term (such as break-even charts and profit graphs), but by far the most important consideration to me is that of direct cost analysis. Although direct costing or marginal costing has been discussed in the literature for many years, I am continuously disappointed with the limited applications of it which are made in practice. To me, the management of a business enterprise is simply a matter of choosing between a variety of alternatives—alternative courses of action, each of which require a direct outlay to get them in motion, and each of which will return a varying amount of revenue, over and above the direct outlay.

No firm can afford to be without this information pertaining to each course of action presently employed, each course of action contemplated, as well as other alternative courses of action which could conceivably be adopted. Fixed costs have nothing to do with these considerations. On the contrary, the thinking of many executives, as well as many accountants, is only made cumbersome by the inclusion of artificial fixed costs per unit which are based upon assumed volume levels and which are derived from highly arbitrary allocations of fixed costs.

In determining courses of action, the fixed costs of a firm remind me somewhat of the cost of an investment in securities in determining what disposition to make of the security. Let me illustrate, by referring to a situation with which I was confronted recently, in dealing with one of the University's investments. We were confronted with the following facts regarding one of our common stock investments: The stock had ranged in price over the last 10 years from a low of $5 to a high of $50. The present market price was $20. The current outlook for this particular company was somewhat uncertain. However, the stock was currently paying a dividend of $1.60 annually, thereby producing a rather healthy yield of 8 per cent based upon current market price. The question which confronted us was whether to sell this stock for $20 and reinvest the $20 in some other stock which had a more certain outlook, or whether to leave the $20 in the original investment.

In posing this question to a number of people, the immediate response in every instance was the question "What did the stock cost us originally?" I maintained then and I maintain now, that the cost of the original stock had no bearing whatsoever upon our decision to keep it or to sell it. (Remembering, of course, that the University is subjected to no taxes whatsoever.) The choice here was a simple matter of alternatives. We could either leave our $20 invested in the original stock, in which case certain prospects for return existed, or we could take that $20 and put it into one of several other alternative investments, each of which carried with it certain prospects for return. These, and only these, are the significant factors for consideration. Yet it was virtually impossible to persuade any of several people to indicate a suggested course of action without their insisting upon knowing the cost of the original stock. From subsequent events, it was quite clear that if our original investment had cost $5 there would have been little reluctance to sell the stock for $20. But, as was actually the case, since the original cost had been $40, there was now extreme reluctance to sell the stock for $20. Here is a clear case of how a sunk cost can improperly influence managerial thinking.

Fixed costs in many enterprises are about like the cost of this investment: They are sunk costs which have little, if any, bearing upon present choice of alternative courses in action. Accountants should be constantly probing and searching for new, feasible courses of action, with a view toward their potential return of revenue over and above direct variable costs. Out of these analyses will come related studies such as make or buy decisions, the utilization of unused capacity, and the conversion to improved machinery.

Cash Projections

The final step in a complete profit plan is the development of a cash projection which is invaluable, indeed almost indispensable in the proper financial planning of an enterprise. With the help of one of my colleagues, Mr. William B. Slocum, of the Department of Accounting at OSU, we recently encountered some interesting problems of cash projection in our work with the Ohio Department of Highways. This application illustrated neatly the effective combination of accounting techniques with statistical procedures and electronic machine methods.

The construction of major highway projects requires on the average of from two to three years. Cash payments are, of course, made to the contractors continuously over this extended period, based upon periodic estimates of percentage of completion. The laws of some states require that all of the needed cash for the project must be on deposit in a bank before the project is initiated. This short-sighted view means, of course, that great amounts of cash are lying idle and leads to considerable delays in the utilization of much needed highways. Fortunately, Ohio is not one of these states. We in Ohio are permitted to let contracts against estimates of future revenues. This permits us to build highways almost simultaneously with the collection of gasoline taxes and other revenues. However, it requires the utmost skill in timing cash outlays to contractors in correlation with the collection of the revenues.

With a Highway Director who was pressing for utmost speed in highway construction, it became apparent that the utmost precision would be needed in this matching. The timing of the collections of gasoline taxes and other revenues was fairly simple and quite accurate, based upon previous experience with these collections adjusted to reflect known trends in increased highway usage. The greatest challenge came in deriving accurate methods of predicting cash payments to contractors working on hundreds of different projects over the state two to three years in advance. After attempting several methods, we discovered that a highly accurate statistical experience could be developed for cash payments at each stage in the development of a particular type of contract. In refining this method we finally settled upon approximately 40 different types of contracts. For each of these types a statistical experience was developed based upon hundreds of performances in the past and which indicated a percentage of the total cost which would be paid in each month in the life of the contract.

In order to keep our projections as current as possible, and knowing that conditions changed rapidly, we realized that we would have to make an application of our statistical experiences to the actual contracts at least monthly. This, we realized, would involve untold clerical hours each month, taking the amount of cash remaining to be paid on each of hundreds of contracts, ascertaining the number of months remaining in which the work was to be performed, and then applying our statistical experience percentages by months in order to arrive at the cash requirements in each month. At this point, it was quite apparent that we had a combination of circumstances which were ideally suited to an electronic data processing machine, with a memory device.

Since such a machine was available in the Highway Department, we soon had all of our 40 experience tables stored into the memory device, and a deck of cards prepared including all of the essential data pertaining to each contract. As each card passed through the machine, representing a contract, the appropriate experience table was selected for its particular type. The machine ascertained the remaining number of months and applied the appropriate cash requirement percentages to each month and determined the amount of cash which would be required in that month. Accordingly, as frequently as necessary, a new complete cash requirements schedule could be prepared by months extending two to three years into the future. One of our colleagues suggested, somewhat facetiously, but perhaps not too unrealistically, that we might obtain from the United States Weather Bureau a long-range weather forecast which we might then incorporate as a part of the projection, thereby reflecting the affects of an unusually wet spring construction season.

Summary

We are living in a period of great challenge. With a statement such as this perhaps most of you think immediately of scientific and engineering challenges. But I am convinced that we are confronting even greater economic and social challenges. The opportunities for service by accountants are many and profound. If we remain smug and complacent in our little world of debits and credits, I am convinced that we will, indeed, become a minor field to that of engineering and mathematics. No group in America today which claims to carry the distinction of a profession, can patriotically sit by while other professional groups pick up the challenges. We have more than just an opportunity to be vigorous and forthright in meeting these challenges—it is our patriotic duty.

FOURTH SESSION

THURSDAY, MAY 15, 1958—7:00 P.M.
The Ohio Union—East Ballroom

Presiding:

DEAN WALTER C. WEIDLER, *College of Commerce and Administration, The Ohio State University*

Greetings:

PRESIDENT NOVICE G. FAWCETT, *The Ohio State University, Columbus*

Address: "Sacrifices for Freedom"

ARTHUR S. FLEMMING, *President, Ohio Wesleyan University, Delaware*

Presentation of distinguished accountants elected to The Accounting Hall of Fame

PRESIDENT FAWCETT, conferring honor

RUSSELL H. HASSLER, *Chairman, Board of Nominations, Professor and Associate Dean, Graduate School of Business Administration, Harvard University*, presenting the candidates

HARRY ANSON FINNEY
ARTHUR BEVINS FOYE
DONALD PUTNAM PERRY

FOURTH SESSION

Chairman Walter C. Weidler: Ladies and gentlemen, honored guests:

Many of you in this audience are our own alumni. Many other universities are represented in your training. Some of you have risen to high place in your profession, through ambition and sheer intellectual drive, without benefit of regular university attendance.

All of you, however, regardless of background, have much in common. As members of a great and demanding profession, your outlooks are scholarly. Serious and continuous study characterizes your lives. You are all, I am sure, interested in what goes forward in university education for business in general and for accounting in particular.

When we were together two years ago, I told you something of the changes made in our Commerce College undergraduate programs. I made particular reference to the larger place made in our program for general or basic education. I spoke of the extension of our English requirement to include additional work in composition. I spoke of the minimal six-hour requirement in the humanities, the courses to be chosen from the fields of literature, fine arts, philosophy, music and speech. I spoke of the increased emphasis given to general business education by requiring of all students enrollment in the common courses, public finance, money and banking, problems of labor, statistics, principles of insurance, business law, corporation finance, principles of management, marketing. We, of course, require at least one full year of work in accounting of all of our students, irrespective of their field of special interest. I also told you that we had increased the number of elective hours available to our students in their Junior and Senior years.

Since my report of two years ago, the University has created another committee to give further attention to the subject of general education. This committee, under the chairmanship of Vice President Heimberger, includes representatives from the five undergraduate colleges of agriculture, arts and sciences, commerce and administration, education and engineering. Its concerns include such consideration as the adequacy in terms of student time given to general or basic education as distinct and apart from vocational education. The committee seeks to discover possible common denominators of general education in terms of areas of instruction. This University committee will also, I hope, run in critical review current course structures in terms of their validity for general education.

Concurrently, our own college committee on instruction is again subjecting our college programs of instruction to critical review in the light of this continued interest in general education. In this connection I should observe that our college committee deems it a privilege to work with the five-college committee on general education.

Perhaps I should pause at this point to observe that in all of these things the College has had the most cordial and sympathetic cooperation of its Accounting Department. Indeed, the chairmanship of the college committee on instruction was these past few years in the very able hands of Professor Paul Noble, and now works currently under the effective chairmanship of Professor Paul Fertig. You recognize both of these gentlemen as members of the Accounting faculty.

Our college committee on instruction is also giving consideration to our mathematics requirement. This re-examination stems in part from developments in the general field of data processing. Under the leadership of our Accounting Department, and under the chairmanship of our own Professor Daniel Shonting, there has been organized a Faculty Seminar in Data Processing. This Seminar, with faculty attendance from all of our Commerce Departments, indeed with representatives of other colleges and from business as well, has met regularly these past few months. Through this medium of faculty education we trust that we shall be able to determine more intelligently our educational roles on both undergraduate and graduate levels. Certainly this approach should give us valuable background for the possible revision of the mathematics department.

I am quite sure that no one can pick up newspapers or magazines today without noting the unparalleled focus on problems of education. As might well be expected, collegiate business education has not escaped attention. Indeed, two very significant contemporary studies of collegiate business education antedate Sputnik.

Some two years ago a study of collegiate business education was launched with the support of the Carnegie Foundation. This study is under the general direction of President Pierson of Swarthmore. One purpose seemingly in mind in the selection of President Pierson was to achieve something of the objectivity which might be inherent in his detachment from collegiate business education as such. President Pierson made a preliminary report at the recent triennial convention of the honorary Commerce Fraternity, Beta Gamma Sigma.

The second of these studies is supported by the Ford Foundation and is headed by Professor Gordon, an economist from the University of California. Professor Gordon made a preliminary report at the most recent meeting of the American Association of Collegiate Schools of Business.

I was privileged to hear these reports. Their common denominators were:

1. An accent on the importance of general education and a plea that more adequate place be made for general or basic education not only for the enrichment of our lives but as an essential integral part of good vocational education.

2. An accent on the importance of developing student proficiencies, skills in communication.

3. An accent on the importance of the behaviored disciplines. A plea that business education be built more solidly on the basic behavioral disciplines of economics, psychology, sociology and anthropology.

As you know, collegiate business education has rested very substantially on economics. Indeed, much early development in business education had its genesis in departments of economics prior to the establishment of separate schools of business.

However, it is quite clear that Drs. Pierson and Gordon have concluded that business education has not been built so solidly on psychology, sociology and anthropology as might well have been the case.

All of these things certainly mean that collegiate business education is now being subjected to close scrutiny and critical examination.

It is my hope and confident expectation that all of these things will give to business education greater breadth and substance, so that it will be more solidly based than ever before on the behaviorial disciplines and the humanities, and in serving the needs of general education, we will better serve the needs of vocational education as well, and above all, that courses and procedures will be redesigned to give them a new and more challenging intellectual quality. I suppose that in a sense I am making a plea for the larger use of the Socratic method.

In all of these things I am sure that we shall have, here at Ohio State, in the future as we have had in the past, the active support and devotion of our accounting faculty. We shall look forward to the same kind of sympathetic support from the membership of your great profession.

Working together, I am sure that we can help to advance the cause of collegiate business education in general, and accounting education in particular.

In conclusion, may I express our deep appreciation to our speakers and presiding officers. We are deeply indebted to you for your cooperation; for your loyalty and for your friendship. I come now to the introduction of President Novice Fawcett. I want to say to you that he has taken over his duties here with great understanding and with an obvious talent for organization. He is a tremendous worker. I do not know that I have ever seen more happening in a shorter length of time on this campus than he has prompted and inspired. Certainly, we can see great things for this University under his leadership. He has some words of welcome for you at this time. President Fawcett. (Applause)

PRESIDENT NOVICE G. FAWCETT: Thank you, Dean Weidler, distinguished guests at the speaker's table, ladies and gentlemen:

On this campus truly "variety is the spice of life." I have just moved a few minutes ago from the annual "All Agriculture Bar-B-Q", where distinguished members of the faculty and outstanding students are being recognized, to this conference of international significance.

Time has not permitted my counting the number of groups I welcome, or am invited to welcome to this campus, during the course of a year. I sometimes wonder, nevertheless, if the listeners are not duplicating in their minds the thinking of William Pitt, the younger, when he was asked about the propriety of making a speech and replied, "It would be better for the audience to be puzzled by why you did not speak than to wonder why you did."

It is with a sense of great interest, however, that I welcome you to this twentieth Institute of Accounting. I am told that this Institute had its origin in 1937 and, with the exception of one of the war years, has convened annually ever since. Additionally, I am informed that over the years we have had the finest support and the highest level of cooperation of the Accounting organizations represented at these tables tonight. For this manifestation of interest we are indeed grateful.

This brilliant exchange of ideas through association with leaders of your profession has without doubt been a profound and enriching influence on our courses of instruction. When students see and meet men who have written textbooks and articles in professional journals, they are stimulated intellectually and motivated to attain higher levels of achievement. Furthermore, a substantial contribution to accounting literature has been made through the publication of papers and proceedings of this Institute. In fact, *The Accountants Journal*, an English publication, a few years ago rated this Institute as one of the four having international recognition.

As indicated in the brochure which you have, the Accounting Hall of Fame was established in 1950 to honor North American accountants who have made significant contributions to the advancement of accounting. The Board of Nominations, I am told, consists of 45 distinguished accountants in public practice, industrial and government service, and in the teaching profession. We take great pride in honoring the men who have played such a large and important part in the development of your profession.

As is the case of all professions in a day of rapid change, you are confronted with a number of major problems such as higher educational standards, research, widening the scope of professional practice, auditing standards, and the impact of the electronic data processing. You are mindful, I am sure, that your approach to these problems will be from the standpoint of improving the quality of service to your client, your employers and the public.

It is indeed a high privilege for The Ohio State University, through these Institutes in bringing to the campus these distiniguished speakers, to contribute to the solution of these problems.

May I say additionally that I share with you the honor this evening in having on our campus as speaker on this occasion, President Eisenhower's newest appointee to his Cabinet.

May your deliberations at this conference lengthen the shadow of your influence and enrich the lives of all Americans through the statesmanship of the leaders assembled here this evening. Thank you. (Applause).

DEAN WEIDLER: Mr. President, thank you.

You are all, I am sure, so well acquainted with the talents, public service and the distinguished career of Dr. Arthur S. Flemming as to make a lengthy introduction quite unnecessary, indeed superfluous.

A native of New York State, Dr. Flemming took his A.B. degree from Ohio Wesleyan in 1927, his A.M. degree from American University in 1928. Then followed an L.L.B. degree from George Washington University in 1933.

At least 16 great American colleges and universities have conferred honorary degrees on Dr. Flemming in recognition of his distinguished services to education, to government and to all the people of these United States.

His notable career includes university teaching, the presidency of his Alma Mater, editorial work on the staff of the *U. S. Daily* (now *U. S. News and World Report*), membership in the U. S. Civil Service Commission, chairmanship of the Management-Labor Policy Committee of the War Manpower Commission, membership on the President's Advisory Committee on Government Organization, Director, Office of Defense Mobilization, Member National Security Council, and by invitation of the President, participation in meetings of the President's Cabinet.

His committee membership list is a most imposing one. Time limitations preclude their enumeration. Recent appointments include the chairmanship of the Commission on the Survey of Dentistry of the American Council on Education, and the chairmanship of a statewide Citizens Committee on Highways to which he was appointed by Governor William O'Neill this past August.

His most recent appointment as Secretary of the Department of Health, Education and Welfare was announced just last week.

All of these things add up to a life of great distinction and outstanding service. I feel rarely honored and privileged to present Dr. Arthur Flemming to this audience. His topic is "Sacrifices for Freedom." Ladies and gentlemen, Dr. Flemming. (Applause)

SACRIFICES FOR FREEDOM

By ARTHUR S. FLEMMING
President, Ohio Wesleyan University
Delaware, Ohio

Dean Weidler, President Fawcett, distinguished guests, participants in this twentieth annual Institute of Accounting:

May I say that it does give me a great deal of pleasure to have the opportunity of participating in this Institute. As you can appreciate, I have been one of the consumers of accounting, both inside and outside of government. As I looked at the names of those who have been selected for membership in this Hall of Fame, I realize that at various stages in my career, I have had the privilege and the opportunity of working with some of the most distinguished leaders of this profession.

Back in the 1930's I was asked to become the first Director of the School of Public Affairs of the American University in Washington. At that time we thought that it would be helpful and useful if we introduced a course in government accounting. We looked around to see if we could find someone who would undertake the responsibility for such a course. I recall very distinctly being referred to Carmen Blough, who at that time was with the Securities and Exchange Commission. I went to him, talked with him about the possibility of his offering such a course. He pointed out to me that it would be a pioneering type of activity, but nevertheless he agreed to do it, and we were able to get a program under way in that particular area. I do not need to tell you that Carmen Blough did an outstanding job.

Then soon after World War II, when I was serving on the Civil Service Commission, one day a member of our staff came to me and said, "You know, there is a new person at the General Accounting Office who has come in to handle corporation accounting. He is really stirred up over this Civil Service system. He says if he can not get out from under Civil Service, he is going to quit and go back to Richmond, because he can't do the job." Then this staff member said, "I think you had better call him up and ask him to have lunch." I followed that suggestion; I asked Coleman Andrews if he would have luncheon with me. That was the beginning of a series of conferences to see how we could achieve the objectives he had in mind for that phase of the work of the government in the General Accounting Office, and at the same time do it within the framework of a Civil Service system. Because of Mr. Andrews' thoughts, we were able to work out a program which helped to strengthen the Civil Service system.

I also noticed that there is another gentleman in this Hall of Fame by the name of Percival Brundage, who has just stepped out as Director of the Budget. During my period of service as Director of the Office of Defense Mobilization, I had a good many contacts with Mr. Brundage, and found him to be an outstanding public servant.

I am happy that it has been my privilege to come to know these three leaders of your profession. Personally, as one who has been on the receiving end of the results of the activities of this profession, both in government and outside of government, I have come to have the highest regard for the contributions that you have made and are making to sound management practices, both inside and outside of government. You have set, as a profession, high standards of performance. You have provided the inspiration and the leadership which has made it possible for many members of your profession to achieve these high standards. All of us who have been called upon, or are called upon to occupy administrative positions are deeply indebted to you.

As you look to the future, I hope personally that your profession will place increasing emphasis on the contributions that you can make to speeding up the decision-making process, whether it is in government or outside of government. I personally feel that one of the major problems confronting us today in the field of government is how we can improve the decision-making processes so as to enable us to obtain quick and sound decisions. We can no longer afford the luxury of leisurely trying out one course of action, and then if that does not work, trying out another. The world is moving too fast for that.

I know of no profession that is in a better position to help achieve this objective. I hope, therefore, that, as you come together from time to time, you will think in terms of the contribution that you as a profession can make to enable governmental agencies, business organizations, educational organizations, and all other types of organizations to make quick and sound decisions.

This evening, because of the key role that you are playing in the life of our day, both within your profession and also as citizens of your community, I would like to lift up for a few moments an objective which should be, it seems to me, of special concern to all of us in these days. As I lift up this objective, I am thinking particularly of some of the things that have been going on in this world just within the last 10 days.

Yes, I am thinking of the Vice President's trip to Latin America. I am thinking of what is going on in France tonight. I am thinking of what is going on in the Middle East.

We should have, as one of our deepest concerns, it seems to me, this objective: To make the maximum possible contribution to the preservation of the concept of freedom and to its acceptance by those peoples who are either enslaved, or who are wavering tonight between slavery and freedom.

I believe that if this objective it to be achieved—if we as a nation are to make the maximum possible contribution toward the achievement of such an objective, you and I as citizens must be prepared to a greater extent than ever before to express our thankfulness for freedom.

I am sure that your response to that statement is that there is not a person in this room tonight who would not be willing to express his thankfulness for freedom. Yes, I think that is probably true, but are we, and are our fellow citizens, willing to give expression to this thankfulness in a truly meaningful manner?

The Psalmist in the 118th Psalm asks this very significant question. "What shall I render unto the Lord for all of his benefits toward me?" And then a little later on in that Psalm he answers his own question, "I will offer unto Thee the sacrifice of thanksgiving."

In other words, when we are truly thankful, we will express our thankfulness in deeds as well as in words—deeds which can be described by just one word, namely, sacrifice.

What are some of the sacrifices which we should be willing to make as citizens of this nation in order to preserve freedom in our own land and throughout the free world? This, in order, as Eltin Trueblood puts it, to prevent the tragic division of the world into two camps, by the penetration of the whole earth with the ideal of a free society.

What are some of the sacrifices we should be willing to make in order to express in a meaningful manner our thankfulness for freedom?

First of all, it seems to me that we must as citizens of this nation be willing to make sacrifices in order to strengthen the foundation on which our form of government rests. The person who does not even take the trouble to vote is not very thankful for freedom. As you read the statistics about the percentage of persons who participated in the recent primary election in the State of Ohio, are you proud? I am not. I am disappointed to think that such a small percentage of those who have the right to vote are willing to make whatever sacrifice of time is involved in order to exercise that right.

Then, also, I have a conviction that the person who does not play an active part in the political party of his choice has failed to express his thankfulness for freedom.

You and I know that to a very large extent the standards of conduct that prevail within our political parties determine the standards of conduct that prevail within government itself. If we are really interested in strengthening our government, if we are really interested in strengthening the foundation on which our form of government rests, we will expand the time and the energy that is necessary in order to be active participants in the political party of our choice. It is my feeling that if we do not do that, we are not really thankful for freedom.

Likewise, it seems to me that the person who, for purely personal reasons, turns aside from the opportunity of serving in public office is not thankful for freedom. Here is a school board in one of our communities. Here is also a person who is well qualified to serve as a member of that school board. He is provided with the opportunity of doing so. He thinks in terms of the issues on which he is going to be required to vote, if he serves. He says to himself, "No matter how I vote on these issues, it is going to affect my business. Therefore, I will not serve." My feeling is that such a person is not thankful for freedom. He is unwilling to make a sacrifice in the interest of preserving freedom as we know it in our nation tonight.

But also as we think in terms of our nation, and as we think in terms of the world of which we are a part, I am sure that each one of us would agree on the fact that we must, if we are truly thankful for freedom, make sacrifices in order to make it possible for the United States and the other nations of the free world to deal with the forces of Communism from a position of strength, rather than from a position of weakness.

The events of the past 150 days have certainly served to underline the importance of such sacrifices. We have an obligation as citizens to make sure of the fact that we never give our elected representatives in the Congress of the United States, for example, the impression that we are more interested in retaining some of the luxuries of life than we are in maintaining this position of strength. It is only as we keep ourselves in a position where we can deal with the forces of Communism with strength rather than with weakness that we can hope to deter the aggressor, and thus prevent World War III. We must make sacrifices in order to maintain this position.

Likewise, it seems to me we must make sacrifices in order to help our neighbors, individuals and nations, to realize their highest possibilities. At the very heart of our Judeo-Christian tradition is the Commandment, "Thou shalt love thy neighbor as thyself." This Commandment, it seems to me, places upon us a common responsibility, a responsibility to help our neighbor realize his highest possibilities. It is a law of life, a law which, if broken, breaks the life of the law breaker and disrupts the society of which he is a part. The acceptance of this Commandment provides a center and a direction of life, and this in turn motivates and inspires men and women to make sacrifices in order to fulfill the law in their own lives.

Because of your contact with the life of your communities, you know that the enemies of freedom thrive in a climate of indifference to the welfare of others. A community that fails to provide its welfare agencies, for example, with adequate support, is violating this basic law of life, and is playing into the hands of the enemies of freedom. We must be willing to make sacrifices in order to make it possible for a United Fund drive to succeed in our community, so that the welfare agencies of our community can meet the needs of our neighbors, and can help our neighbors to realize their highest possibilities. Any time that a United Fund Drive fails in our community because of our unwillingness to make sacrifices, we are undermining the foundation on which freedom rests.

Also a community that refuses to provide adequate educational opportunities for all young people irrespective of race, color or creed, is violating this basic law of life, and by so doing, is providing a fertile soil for the enemy of freedom.

Personally, I believe that as a society we must be willing to make far more sacrifices in order to provide adequate educational opportunities than we have been willing to make up to the present time. No one will dispute the fact that, as of tonight, it is not possible for the United States, through its existing educational facilities to help all of our young people to realize their highest potential.

The reason why we are not in a position to do it is because of our unwillingness as a society to make sacrifices in behalf of education as an expression of our thankfulness for freedom. There is not any doubt in our minds, but that if we are going to attract and retain outstanding men and women as members of the teaching profession, at all levels of education, and in private and public institutions, we must in the next few years double the salaries that we are now paying the members of the teaching profession. We know this to be a fact. Are we willing to make sacrifices in order to achieve such a goal?

I hope I make myself clear. I am not talking at all about what portion of this burden the federal government should carry. I do not have any intention of making any talk dealing with that problem until I have been in office for a period of time. As I look at the total educational picture, and as I think of the total investment that is being made from public and private sources in our educational system, I am proud of what we have done as a nation. But at the same time, I am conscious of the fact that we have not yet traveled the second mile. Are we going to do it, in order to make it possible for our young people to realize their highest potential? Are we so thankful for freedom that we are willing to make this kind of a sacrifice?

Then as we think in terms of helping others to realize their highest potential, I am convinced of the fact that the surest way for the free world to lose the battle for the hearts and minds of men is for it to violate this basic law by refusing to use its resources in order to help, for example, the peoples of the Far East and the Middle East to realize their highest potential. I believe that nations, like individuals, can find or save their lives only as they are willing to lose them in dedicated but intelligent service in behalf of other peoples.

I think that as citizens, we have some things to think about in this particular area. When we discover a weakness in our program for the production of missiles, we immediately start to work with renewed determination to correct the weaknesses. We immediately appropriate billions of additional dollars in order to further the program. And it is right and proper that we should do this.

But over in the field of mutual assistance, when we make mistakes—mistakes in the field of human relations—some conclude that the thing for us to do is to abandon the program, or at least to cut down on the amount of money that we are spending.

Why is it that we do not approach mistakes that we may make in this particular area in the same spirit in which we approach mistakes that we make in the area of missile production?

I believe that as a nation we have to accept the fact that we have an obligation to love our neighbors, to help our neighbors realize their highest possibilities, and that it is going to be necessary for us to make sacrifices if we are to achieve this goal. I also believe that if we do not achieve the goal, we are deliberately standing by and permitting the foundations on which freedom rests to be undermined.

Not only must we be willing to make sacrifices in order to strengthen our form of government, not only must we be willing to make sacrifices in order to help our neighbors, individuals and nations to realize their highest possibilities, but I also believe that we as citizens, if we are truly thankful for freedom, must be willing to make sacrifices in order to strengthen our spiritual foundations.

Our nation will be spending next year up to $43 billion on a defense program. We are spending it in the hope that we can deter the potential aggressor. But I also believe that we are spending it in order to buy time until spiritual forces can provide us with a spiritual break-through that will ultimately lead us into a pathway of peace. But this spiritual break-through will take place only if each one of us is willing to make his contribution to setting spiritual forces into motion by making sacrificial faith gifts of time, energy and resources to the work of the faith and church of his choice.

I have been away from Washington for about 18 months. I had four years in the Office of Defense Mobilization. During those four years I listened to many briefings dealing with the capability of man to destroy himself. Those briefings could leave a person in a very discouraged and pessimistic frame of mind as he looks to the future, because that capability is beyond the comprehension of any human being. Frankly, however, I did not leave my position as Director of Defense Mobilization with a feeling of pessimism, or with a feeling of discouragement. That position gave me the opportunity of going all over this nation, talking with groups of citizens, and oftentimes participating in question and answer periods following those talks.

As a result of these experiences, I came to the place where I concluded that, by and large, the American people are thankful for freedom. I believe the American people are so thankful for freedom that when issues are put before them squarely and forcefully, they are willing to make whatever sacrifice it may be necessary to make in order to preserve freedom in our own nation, and in order to make it possible for us to bring men and women in other nations throughout the world to the point where they likewise accept the concept of freedom, and where they likewise are willing to make sacrifices in its behalf.

DEAN WEIDLER: Thank you, Dr. Flemming, for a truly great and very moving address. We are certainly very deeply in your debt.

We come now to the Accounting Hall of Fame ceremony. The recipients of the awards will be presented by Professor Russell H. Hassler, who will also read the citations. Professor Hassler is Chairman of the Board of Nominations of the Accounting Hall of Fame, Professor and Associate Dean of the Graduate School of Business Administration, Harvard University.

President Fawcett will confer the honors.

Ladies and gentlemen, Dean Hassler and President Fawcett.

DEAN RUSSELL H. HASSLER: President Fawcett, Dean Weidler, honored guests, ladies and gentlemen:

Harry Anson Finney is probably best known as an author. An Iowan by birth, he received a Ph.D. degree from the University of Chicago in 1913, and continued graduate studies at Northwestern University.

He has practiced several careers at the same time. As a practitioner, he served for many years as a partner in the firm of Baumann, Finney & Company, of Chicago, Illinois. As an educator he was professor of accounting at Northwestern University from 1920 to 1943. Harry Finney published his first book in 1916 to be followed by some nine others, with many editions and numerous articles. Hundreds of thousands of students have come to know the name Finney as the author of their textbook in accounting, and to be influenced by him.

He has served as president of the Illinois Society of Certified Public Accountants, and has been a member of the Committee on Accounting Procedure of the American Institute of Certified Public Accountants.

In 1957 at the annual meeting of the American Accounting Association Mr. Finney received the Alpha Kappa Psi Award for outstanding service in the field of accounting.

As an educator whose crisp, articulatie writing has made the world his classroom, the Board of Nominations is happy and proud to present Harry Anson Finney.

MR. HARRY ANSON FINNEY: I am very glad I am not in a position an accountant from Iowa found himself in when a note was delivered to his desk in the House of Representatives. It came from a constituent. It said, "I shall be in the gallery for the next half hour, and I hope that while I am here, you will say something that will go down the ages."

My assignment is less exacting. I was told that I would be expected to make a few remarks that were appropriate to the occasion. I shall do that. And here are the remarks.

This is the greatest honor that has ever been bestowed on me. I am deeply appreciative of it, and very thankful. (Applause)

DEAN HASSLER: Arthur Bevins Foye combines the qualities of a vigorous leader in his profession with those of a responsible citizen active in the affairs of his university and his nation.

He graduated from New York University (*magna cum laude*) in 1914 and began his career as an instructor in accounting at that same university.

His professional career as a practicing public accountant has been with the firm of Haskins & Sells. He has been a member of that firm since 1923, and served as senior partner from 1947 to 1956.

He has served his profession as president of the New York State Society of Certified Public Accountants, and in 1953-54 as its president led the American Institute of Certified Public Accountants to a year of great achievement.

He has served his university as a member of its Board of Trustees; as president of the New York University Alumni Federation; president of New York University Men in Finance Club; and president of the Commerce Alumni Association of New York University.

He has served his nation as a member of the Foreign Operations Administration Task Force of the Hoover Commission on Organization of the Executive Branch of the Government, and as a member of the Mutual Security Agency of the Survey Group of Great Britain.

As an interested participant in improving our relations with other peoples he has worked actively as a director and member of associations concerned with European, African and Asian affairs.

In 1957 the American Institute of Certified Public Accountants presented Mr. Foye an award for service to the profession and summarized his achievements with these words:

"In recognition of his undiminishing devotion to the profession and to good will between other nations and his own . . . ."

As one personifying by his actions and interests the role of leadership in his profession, the Board is happy and proud to present Arthur Bevins Foye. To receive the Award for Mr. Foye is Elmer Beamer, partner of Mr. Foye in Haskins & Sells.

MR. ELMER BEAMER: Mr. Foye asked me to express his sincerest regrets over his inability to be here. He had accepted an invitation to speak on the West Coast tonight before he knew of this honor. It is typical of him that he chose to carry through that opportunity to serve, rather than to come here for personal honor.

He did however send you this message: "I regret that I cannot be present at this dinner to receive the nomination to the Accounting Hall of Fame, because it is a normal human failing to value recognition by those in one's own profession. I feel, however, that it must be accepted on behalf of many others, as well as myself. Today, in industry and in the profession, it is the organization back of a man that makes him effective.

"It has been my good fortune to have had back of me organizations of able, keen minded, devoted men, indefatigable in their associations, that made my task not only easy, but pleasant, so that whether I am conscious of the honor done me, I accept it for the many who must be nameless, but whose thoughts and efforts enabled me to take advantage of opportunities.

"As an example of organization versus men, I recall that I was in Columbus in 1915 when the American Association of University Instructors in Accounting was formed, with the then few but well-known, and still well remembered leaders in accounting instruction, John R. Wildman, Fay Ellwell, Henry Rand Hatfield, Herman Scoville, William A. Hott.

"Today there is a great organization, the American Accounting Association, with 15,600 members, and a strong influential program. Its strength and greatness, however, lie in the many who devote themselves to it, and not merely to the person who leads it.

"And so it is in today's world, but despite my consciousness of this, I am appreciative of the honor conferred on me, and through me on those around me." (Applause)

DEAN HASSLER: A professional in public accounting practice, Donald P. Perry was a skillful leader devoted to raising standards of education and experience.

He graduated from Harvard College in 1916. His business career was with Lybrand, Ross Brothers & Montgomery, of which he was a partner.

Mr. Perry has been chairman of the Massachusetts Board of Registration and chairman of the American Institute of Certified Public Accountants Board of Examiners. He has also served as president of the Massachusetts Society of Certified Public Accountants and vice president of the American Accounting Association. At the time of his death, he was a vice president of the American Institute of Certified Public Accountants.

In 1951 he proposed the creation of a commission on standards of education and experience for Certified Public Accountants, and was later asked to serve as chairman of this commission. Under his chairmanship, the commission, undertaking a most difficult assignment, offered new and challenging recommendations for improved standards of education and experience in its report published in 1956.

Professional honors to Mr. Perry have been many. In 1955 he was appointed Dickinson Lecturer at the Harvard Graduate School of Business Administration, speaking on the subject, "Public Accounting Practice and Accounting Education." In 1956 at the annual meeting of the American Accounting Association he received the Alpha Kappa Psi Award for outstanding service in the field of accounting. In 1957 he received the American Institute of Certified Public Accountant's award for distinguished contribution to this profession.

For his unstinting efforts to advance public accounting practice through improving accounting experience and education, the Board of Nominations is proud and happy to present Donald P. Perry. To receive this award is his son Donald Perry. (Applause)

PRESIDENT FAWCETT: It is an honor for me to confer on your father, through you, this award, identifying him as a distinguished member of the Accounting Hall of Fame.

MR. DONALD PERRY: President Fawcett, Professor Hassler, I am, of course, very proud to accept this award for my father, and I thank you all very much for giving me the opportunity to do so. It seems only appropriate that this award should be made by The Ohio State University, since he was always very, very deeply concerned with the training and education for accountants. Thank you very much. (Applause)

CHAIRMAN WEIDLER: Thank you, Dean Hassler and President Fawcett. May I thank you for being such a wonderful audience.

Ladies and gentlemen, we are adjourned.

FIFTH SESSION

FRIDAY, MAY 16, 1958—10:00 A.M.
The Ohio Union—West Ballroom

Presiding:

C. ROLLIN NISWONGER, *President, American Accounting Association; Professor, School of Business Administration, Miami University, Oxford*

Paper: "Tax Problems in Buying and Selling Businesses: Some Basic Considerations in Choosing the Form of the Transaction"

NORMAN A. SUGARMAN, *Baker, Hostetler & Patterson, Cleveland*

Paper: "Current Trends in Fringe Benefits"

MATTHEW F. BLAKE, *Partner, Hurdman & Cranstoun, New York*

Paper: "Internal Revenue Service Technicians: Yesterday and Tomorrow"

L. HART WRIGHT, *Professor, University of Michigan Law School, Ann Arbor, Michigan*

TAX PROBLEMS IN BUYING AND SELLING BUSINESSES: SOME BASIC CONSIDERATIONS IN CHOOSING THE FORM OF THE TRANSACTION

By NORMAN A. SUGARMAN
Baker, Hostetler and Patterson,
Cleveland, Ohio

The importance of considering Federal income tax consequences in making business decisions has become generally recognized. However, in some areas tax effects are so important that they may ultimately determine the very nature and form of the transaction. This is particularly true in the purchase or sale of a business, where the tax consequences can be the deciding factor as to whether the transaction will be completed—and with what success.

In the purchase or sale of a business, both lawyers and accountants may have great responsibilities and they can play a very important role in connection with the ultimate results of the transaction. Frequently lawyers and accountants are called upon for assistance in such transactions not only with respect to their technical professional fields, but also as business advisers. It is at this point that it is particularly important that they recognize the relationship between business planning and tax planning in meeting the objectives of a client. In addition, they should be able to exhibit that degree of imagination which will permit the presentation to the client of various methods of accomplishing his purpose. With this, however, goes the responsibility for knowing of problem areas in the tax laws and alternatives under the tax laws.

The purpose of this paper is to suggest the need for imaginative thinking in planning transactions such as the buying or selling of a business; and by way of illustration, to present a survey of methods available under the tax laws, even though such methods are not ordinarily thought of as methods for the purchase or sale of a business. This survey will not attempt to state in detail the technical rules, but rather it is presented with the view that a compendium in this field will be helpful to the adviser who will then further realize the necessity of "checking out" the details under the law.

A first consideration for the adviser is the objective or objectives behind the sale or acquisition of business interests. Exploration with the client of objectives may cast an entirely new light upon the purpose of the transaction and is usually particularly helpful in determining the importance of tax considerations in shaping the form of the transaction. There may be a number of objectives, each of which should be analyzed. One objective may be simply to accomplish a business and dollar result to the best advantage. Another objective in some cases may be personal and estate planning. A third objective, which may be related more directly than the others to taxes, may be to reduce the cost of doing business through a transaction designed to provide some tax advantages.

Whether or not the objectives encompass one or all of the above in a particular situation, the adviser should relate whatever objectives exist to methods available under the Internal Revenue Code for accomplishing the desired purposes. The tendency in recent years has been to write the tax laws so as to cover more and more particular situations and to prescribe, in the law itself, tax consequences based upon the form of the transaction. For various reasons, the transactions described in the Internal Revenue Code may not be couched in language which immmediately suggests the sale or purchase of a business. However, imagination in the possible application of many provisions may show that they are suitable for accomplishing such a desired purpose. While attempting to find a tax provision to provide the framework for a business transaction may appear to be putting the cart before the horse, nevertheless, this method may frequently be the shortest route for developing the ultimate form of the transaction where tax considerations will play an important role.

The Federal tax avenues which we shall consider in this paper for the sale or purchase of business interests may be grouped generally as follows:

(a) Tax-free combinations of businesses.
(b) Taxable transfers of stock or corporate assets.
(c) Transfers or acquisitions of part interest in a business.
(d) Some areas of special tax problems.

In connection with all of the above, it is necessary to keep in mind that the tax laws deal not solely with form and mechanics, but that there are certain fundamental principles which are inherent or implied under the law. These will be referred to at the appropriate places in the paper.

I. *Tax-Free Transactions.*

Under the Internal Revenue Code, the purchase or sale of a business may be accomplished in a "tax-free" transaction which is called a "reorganization." The statute (§368(a)(1) of the Internal Revenue Code) lists three basic methods for accomplishing such a tax-free sale transaction. In brief, these are:

(a) Statutory merger or consolidation

(b) Transfer of controlling stock of one corporation for voting stock of another corporation

(c) Transfer of assets of one corporation for voting stock of another corporation

These three methods all involve the combination of two or more businesses and therefore they are methods whereby the owners of one business may sell out to another. These transactions are treated as "tax-free" under the Internal Revenue laws for certain fundamental reasons. The basic concept is that the owner's investment in the business continues in the corporation solution and therefore there is not an income realizing event. The tax laws therefore, generally, treat such transactions as ones in which the owners do not realize taxable income on the transfer of their business and in which the acquiring corporation takes over the tax attributes of the selling corporation, with neither corporation having a taxable gain or loss on the transaction. In giving effect to this tax favored treatment, the Revenue Service will seek to apply two additional tests supplementing the mechanics of the statute, namely, continuity of stockholder interest and business purpose in the transaction. Thus, in planning the tax-free sale or acquisition of a business, there must be awareness that these conceptual requirements are to be satisfied.

From the seller's viewpoint, the advantage of a "tax-free sale" of a business is that there is no tax to pay at the time of the sale. In a sense, this may be only a postponement because the old shareholders of the corporate business who receive stock of the acquiring corporation in the transaction carry over to the new stock their cost from the old stock and eventually upon sale of the new stock, may have a taxable gain which will include the gain as it existed in their old stock.

From the standpoint of the purchasing or acquiring corporation, the advantages of such a tax-free transaction are basically two. One advantage is the fact that no cash outlay is required and the assets of the selling corporation may be obtained intact, including cash, upon the issuance of only stock. A second advantage is that the attributes of the selling corporation carry over for tax purposes to the acquiring corporation and these attributes may be sufficiently desirable to make the acquisition especially attractive. The usual major attribute is a high cost basis for the assets of the selling corporation which will permit greater deductions for depreciation. Thus, if a corporation is enabled to acquire the assets of another corporation and the purchase price in stock is less than the cost of the assets on the books of the selling company, the purchasing company can obtain the benefit of such high cost as the basis for depreciation if it acquires the assets for stock rather than for cash.

There may, however, be some disadvantage in these so-called tax-free combinations of businesses. From the viewpoint of the stockholders of the selling corporation, exchanging stock for stock, while a tax-free transaction, merely exchanges the form of investment and may not necessarily give the stockholder a better investment or a realizable value. A possible method, which may give the selling shareholders some protection, is the use of the voting preferred stock; for, while tax-free transactions generally require the selling shareholders to obtain voting stock, preferred stock may be used as well as common stock. Thus, in the case of the sale by one business to another where shareholders of the selling corporation are interested in income, the issuance of a voting preferred stock to them in exchange for their interest in the old corporation may be a preferable method of accomplishing the sale or exchange whereby the old shareholders pay no tax on the transaction and are assured of continuation of their dividend income. A note of caution, however, is that care must be exercised in avoiding special problems that sometimes arise with preferred stock.

From the viewpoint of the acquiring or continuing corporations, a tax-free acquisition may also have certain disadvantages. One disadvantage may stem from the attributes of the old corporation which will be carried over. While as previously pointed out, there may be an advantage in acquiring a corporation with assets having a high basis, similarly a disadvantage may arise where a corporation is acquired in a tax-free transaction if the assets have a low basis. Perhaps even more important is the fact that in a tax-free transaction all of the assets are acquired and carried over to the acquiring corporation with the same allocation on the books of the acquiring corporation as they had on the books of the selling corporation. Thus, such nondepreciable items as good will would be carried over and likewise the basis of assets would be carried over without regard to the fact that a different allocation of real value was in the minds of the parties at the time of the transaction. A somewhat different result can be obtained if the assets are purchased for cash, as will be described later.

Particular attention should be given to certain accounting aspects in connection with tax-free combinations of businesses. Section 381 of the Internal Revenue Code provides for the carry-over of certain attributes from the selling corporation to the acquiring corporation in these transactions. Many of these attributes involve matters accountants regularly determine, such as, the method of accounting, inventories, computation of earnings and profits, etc. Careful scrutiny is necessary to determine whether it is advantageous or disadvantageous to carry over tax attributes of these items from the selling corporation.

Another rule, which may come as a surprise to some accountants, is the requirement under the new tax law (Internal Revenue Code of 1954, §381(b)) that the taxable year of the selling corporation must end on the day of the distribution or transfer of substantially all of its assets to the acquiring corporation. This may cause the selling corporation to have two taxable periods in what would otherwise be one accounting period. Particular attention must therefore be given to the time of the transaction, not only from the viewpoint of convenience in closing the taxable year, but also from the viewpoint of the time for proper accrual of items such as deductible expenses.

There are many other situations in which technical problems will rise in using these forms of tax-free combinations of businesses and in which one method of such sale may be preferable over another method of tax-free sale. These important considerations must be evaluated in working out the details of the particular transaction under the law.

II. *Taxable Transactions*

Frequently there is an advantage in having a taxable sale or acquisition of a business instead of a tax-free reorganization. Of course, from a practical viewpoint, there are many transactions that can be accomplished only through a taxable sale.

In general, taxable sales of corporate businesses fall in two categories under the Internal Revenue Code. One is the transfer of corporate assets and the other is the sale of stock.

The sale of the assets of a corporate business may be made either by the corporation prior to liquidation or by the stockholders after liquidation. Important tax differences may result, depending upon which method is used. The Internal Revenue Code of 1954, by the enactment of new section 337, has given great impetus to the sale of corporate assets by the corporation prior to liquidation. Under this statutory provision the sale of most all of the assets of the corporation may be made without tax to the corporation. Upon distribution of the proceeds of the sale to the stockholders in liquidation, the stockholders will of course realize a gain or loss which must be reflected for tax purposes.

Section 337 of the Internal Revenue Code is a mechanical statute and care must be exercised by those seeking to take advantage of it to shape the transaction so as to fit the statutory form. In brief, the statute requires the following three steps:

a. Adoption of a plan of complete liquidation.
b. Sale of such assets as are to be sold by the corporation within one year after adoption of the plan of complete liquidation.
c. Complete liquidation within one year after the adoption of the plan of liquidation.

The penalty for failing to comply with these statutory steps may be a double tax, that is, a tax to the corporation on the gain or income realized on the sale and tax to the stockholders on the distribution on the liquidation.

An alternative method of selling corporate assets is to liquidate the corporation first then have the stockholders sell the assets. This method is fraught with danger which section 337 seeks to avoid; for even though the sale is mechanically made by the stockholders, the Government may attribute the sale to the corporation, based upon pre-arranged plans, with a consequence of a double tax, namely, to the corporation and to the shareholders.

A frequently overlooked method of selling corporate assets is that provided under section 333 of the Internal Revenue Code, the so-called one month liquidation provision. The mechanics provided in this section are advantageous in those cases where the corporation has little earnings and profits. The section permits a corporation to be liquidated without recognition of gain to the shareholders (except that, in general, income is considered as realized to the extent of accumulated earnings and profits). The advantage in using this section of the law lies in the fact that the shareholders may receive the corporate assets without payment of tax and will become liable for a tax on any gain only upon a subsequent sale of the assets. This may be particularly important where the assets can be sold only on an installment sale. On such a sale the shareholders can, by a proper election, report gain only as they receive the proceeds of the sale. By contrast, if the corporation, prior to liquidation, had sold the assets on an installment sale, then (even with the application of section 337) the shareholders would be in receipt of gain on distribution of the installment paper to them, even though they did not receive the cash proceeds of the installment sale until a later time.

As previously indicated, a second category for sale of the corporate business is through the sale of stock rather than assets. The principal non-tax advantage to the stockholders of selling corporate stock rather than assets is that they may divest themselves of the corporation with its liabilities. Otherwise, the tax laws are geared to reach, in general, the same results on the seller's side whether the sale disposes of assets or stock. An important exception where differences do exist is in the case of installment sales.

There are important differences on the purchaser's side depending upon whether the purchaser acquires assets or stock. These important differences may be taken into account in the negotiations to the advantage of one of the parties.

The Internal Revenue Code of 1954 sought to eliminate some important differences between purchasing stock or assets of the corporation from the purchaser's viewpoint, by treating certain purchases of stock (which lead to the acquisition of assets) the same as the purchase of assets. Section 334(b)(2) of the Code (like section 337), is a mechanical statute which, in this case, permits the purchaser of stock to treat the purchase as a purchase of assets if the statutory form is followed. In brief, this form involves the following steps:

a. Purchase of 80 per cent or more of the stock in a 12 month period.
b. Causing the acquired corporation to adopt a plan of complete liquidation within 2 years after the completion of such purchases, and
c. Liquidation of the acquired corporation into the acquiring corporation.

As in the case of section 337, the detailed mechanics of this statutory provision must be carefully followed. The advantage of so following the provision is that the acquiring corporation will be able to attribute to the assets so acquired the purchase price of the stock and, where that purchase price is greater than the old basis of the assets in the hands of the selling corporation, the acquiring corporation obtains a "stepped up" basis, such as for depreciation.

The method of purchasing stock, as distinguished from a direct purchase of assets by the seller, may result in important differences where allocation of the sales price between different types of assets has tax consequences. Where stock is purchased, the Revenue Service will invariably require an allocation of the purchase price to assets in the ratio which such assets had on the books of the selling company. This would include, for example, an allocation of cost to a non-depreciable item such as good will. Where, however, assets are purchased directly, the parties may negotiate for specific assets or may, in an arms-length manner, determine the values which are assigned to the assets which are the subject of the negotiations, and through this means build up a sales price. With this record the seller may be able to allocate the purchase price to those assets which it deemed important and which provide the greatest advantages to it from a tax viewpoint, namely, through a higher basis for depreciation.

III. *Transfer or Acquisition of a Part Interest in a Business.*

The categories and methods heretofore described refer, for the most part, to the complete and outright disposition of the business or its assets. An examination into objectives will frequently indicate that a client desiring to sell a business has not realized the possibilities of only selling a part interest in the business. There are a number of provisions under the Internal Revenue Code which may be utilized in transferring ownership or control of a part of a business which frequently will satisfy basic objectives of the taxpayer.

In this connection, it is important to examine the motivation in buying or selling an interest in the business to see what particular mechanic will best fit the situation, especially as to whether from a long-range viewpoint the intent is to expand or contract the business enterprise. In using any of these methods, where only a part interest in a business is disposed of, special care must also be exercised to avoid any distribution being treated as a dividend.

Among the methods generally available for disposing of a part interest in a business are the following:

A. *Sale of assets following a partial liquidation.* Section 346 of the Internal Revenue Code prescribes rules whereby a distribution of assets in a partial liquidation may be treated as a capital gain transaction. This section is particularly applicable to a corporation with multiple businesses and upon distribution of the assets of one of such businesses, including cash, in a contraction of the corporate activities, the distribution to the shareholders will be treated as giving rise only to capital gain. Following such distribution, the shareholders are free to sell the operating assets to another business. Care must be exercised to avoid dividend problems which lurk in such a transaction where stock is distributed. For this the special rules under section 355 of the Code must be examined.

B. *Divisive reorganizations.* The 1954 Internal Revenue Code has a special provision facilitating the splitting up of businesses. In effect, this is a method by which two or more stockholders may sell out their business interest to each other and go their separate ways, without taxable gain or income. The statute permits a corporation business to be split up into two or more corporations, with each of the stockholders taking stock in a separate business, and as long as the allocation of their stock is determined on an arms-length basis, without intentions of a gift or compensation, the respective stockholders will divest themselves of a part interest in the former total enterprise without taxable gain or income.

C. *Transfer of business interests among stockholders or others.* There are numerous methods of transferring a part interest in a business to stockholders or employees or the public without a sale of the entire business. One method is that of a "recapitalization." It will be noted that this term is not ordinarily used in connection with a sale of the business, but the mechanics under the Internal Revenue Code effectively permit a shift of control or ownership in a part interest in a corporation through a "recapitalization" and with no immediate tax to the transferring stockholders. One method is through the issuance of preferred stock (or other type of leverage stock) to a stockholder desiring to be less active and having the corporation sell additional shares of common stock to employees or other new stockholders. In such a case the preferred stock may be received without recognition of gain or income, and upon its eventual retirement the preferred stockholder can realize on his prior investment or activities in the corporation (which have been capitalized through the preferred stock). Care must be exercised in such a transaction to avoid certain problems in the use of preferred stock and on redemption of stock, but the Treasury Regulations indicate the ground rules which, if followed, can lead to a successful completion of the entire transaction. (See sections 302 and 306 of the Internal Revenue Code).

Other methods of disposing of or selling an interest in the corporation to other stockholders may be through selling stock to the public, stock option and stock distribution plans, including stock bonus and profit sharing plans (which purchase stock of the corporation).

IV. *Some Areas of Special Tax Problems.* The above survey deals largely with mechanics and the use of some statutory provisions that are not commonly thought of as involving sales. They are suggested with the view that their imaginative use can accomplish basic objectives within the favorable patterns under the Internal Revenue Code. However, it is equally important that the adviser's imagination should not run away with him at the expense of certain fundamental principles which are the basis for inclusion of these statutory mechanics in the law. Fundamentally, these statutory mechanics are designed to fit business situations and to facilitate business transactions. Accordingly, a fundamental policy under the tax law is that the application of these provisions is subject to scrutiny in any case to prevent their benefits from being availed of where there is a sham transaction. Thus, the adviser must be constantly aware of the importance of a business purpose in the transaction (which may exist in addition to other purposes). He must also be aware that the Revenue Service and the court frequently will look through "step transactions" and reach tax results based upon a net effect test. In addition, there is always the possibility under our tax laws of a change in rules, regulations and legislation.

It is for these reasons that there is a growing practice of requesting advance rulings from the Revenue Service as to the tax consequences of transactions where different tax results than those that had been anticipated would be disastrous or, at the very least, distort the transactions. The advantage of an advance ruling is that it may serve to affirm the adviser's own analysis of the tax consequences and provide a ruling to which the Government will give effect, even though it subsequently may change its policy or position as to other transactions.

There are, however, certain tax problem areas in which special care must be taken and which generally are not the subject of rulings by the Revenue Service. One of these involves the so-called problem of liquidations and reincorporations. In essence, this problem arises where a corporate business is liquidated and some or all of the stockholders begin a new business with some or all of the assets of the old corporation. If the new business is a continuation of the old, then the new business does not obtain the advantage of a "stepped up" basis for assets acquired and the old shareholders may find themselves as treated in receipt of a dividend if they retained any assets from the liquidation and did not plow them back into the new corporation. On the other hand, there is no question that under proper circumstances a corporation may be liquidated and its assets sold to another business without the above penalities. In these cases the realities of whether there is a substantial change in the situation will control. The Revenue Service will give advance rulings in such cases approving a liquidation, even though there is a sale of assets to a new business if the stockholders of the old corporation own less than 50 per cent of the stock of the new corporation. Where there is a carryover of stockholder interest from the old corporation to the new corporation of more than 50 per cent, then although technically the transaction may not fall into any of the "reorganization provisions", the Revenue Service is hesitant to give advance rulings recognizing a bona fide liquidation. While the present situation is not clear, this problem may be avoided by a careful approach in a taxable sale of assets to a related business, if the selling stockholders are willing to take a minority position.

Another special problem area involves that of loss carryovers. Section 381 of the Internal Revenue Code provides for the advantageous carryover of net operating losses from one corporation to another where there is a tax-free combination of the two businesses. However, sections 382 and 269 of the Code contain limitations. The purpose of these limitations is to disallow the deductions for losses carried over where there is a tax avoidance motive. However, the statutory provisions leave much to be desired as to the certainty of their operation. In a general survey, such as this paper, warning flags can only be hoisted at this point in regard to loss carryovers. Unfortunately, the present trend of court decisions seems to be adding to the confusion.

A third major area where there is a special problem involves that of collapsible corporations. The Internal Revenue Code of 1954 was so expanded, in section 341, that the term "collapsible corporation" will apply to many corporations whether being liquidated or continuing. In general, this section imposes the penalty of recognition of ordinary income on the gain on sale of stock or liquidation of a corporation if the corporation is a collapsible corporation. While the statute provides certain rules for the avoidance of the penalty, these frequently are not available in a business with appreciated assets or receivables. Curiously enough, one of the methods of avoiding the penalty may be by a tax-free sale of the stock of a collapsible corporation to a larger non-collapsible corporation. Thus, if stock in a collapsible corporation is exchanged for stock in a non-collapsible corporation, the stockholder will have an investment which may ultimately be sold without the penalty of ordinary income tax.

Conclusion. In this survey the possible use of various provisions of the Internal Revenue Code has been indicated in many sale transactions not ordinarily so referred to under the Internal Revenue Code. The responsibility of the adviser in this connection is to realize that, when his client refers to a sale or purchase of a business, there are tax mechanics by another name which may be suited to these bona fide business transactions. This is a turnabout from the old concept that business purposes were the first and only consideration and that all tax consequences are to be judged by their business purposes. Tax considerations and consequences are now a very important business consideration. It is no wonder therefore that business transactions are being formulated in terms of the forms under the tax laws. The use of these forms, however, should not cause the adviser to lose sight of their fundamental purposes, both from the standpoint of tax concepts and also from the standpoint of facilitating business transactions.

CURRENT TRENDS IN FRINGE BENEFITS

By MATTHEW F. BLAKE
Hurdman & Cranstoun, New York

Up to the present it has not been possible to gauge the impact of the current business recession on fringe benefit patterns. Since the rapid growth in this area occurred during a sustained era of prosperity, we are now in a period which should provide a testing ground of the relative permanence of such benefits in our business picture. Are they necessities stemming from tax advantages or luxuries which will be washed out in a flow of red ink?

Obviously, companies in serious straits will add few, if any, new benefits, being more inclined to find ways to jettison what they already have. On the other hand, the bargaining demands of the United Auto Workers and the Rubber Workers unions are studded with requests for costly changes in pension and other plans.

If they are primarily tax stimulated, the fundamental reasons for growth still exist. The savings to employers and employees will be reduced as incomes are pared down, but there still should be a spread. If an employee receives $1,000 in group life insurance, medical benefits, and pension build-up within a year, the cost to the corporate employer is $480. In lieu of these tax favored benefits in kind, the employee in a 30 per cent bracket would need $1,400 of additional salary, and the one in the 50 per cent bracket would need $2,000 to come out even. After equating the two situations, the cost to the employer would rise to $672 for the employee in the 30 per cent bracket, and $960 for the one in the 50 per cent bracket as compared with $480 for the fringe benefits. However, even though recessions do not alter the simple mathematics of the proposition as long as tax rates remain high, they do affect the employer's ability to pay. In a deep depression, the need for spendable income on the part of employees will tend to outweigh tax advantages. Like many other financial questions left unanswered so far in 1958, the answer seems almost wholly to depend upon the death of the slump. One field in which there will be heightened interest by reason of the current large volume of unemployment is in supplementary unemployment benefits.

Life Insurance

Premiums paid by an employer on group life insurance for its employees are deductible by the employer and non-taxable to the employees. The proceeds are non-taxable to the recipient. To qualify as group insurance, the coverage must be of a renewable term nature, having no cash surrender or loan value and may not be of a level premium or paid up type. Group life insurance is a form of benefit with a relatively low cost to the employer which is richly endowed with tax advantages to the employee. As it fulfills a fundamental need, it usually is the first type of benefit plan to be adopted by a new employer.

Life insurance for pensioners presents some vexing problems. The prohibitive cost of continuing tax-favored group insurance until death dictates at least a reduction in coverage. As distinguished from group term insurance, the delivery of a paid-up policy constitutes taxable income to the employee. One approach is to build a paid-up policy through a cumulative process over a period of years. The annual premiums paid would be deductible by the employer, and would be taxable income to the employee. The purpose behind purchasing the insurance on a piecemeal basis is to stretch out the employee's tax burden which could be substantial if the entire value of the policy were to be taxed in the year of receipt of a paid-up policy. Another approach would be a contributory plan in which the employee would finance the paid-up element, and the employer would pay for the term insurance coverage. Any amount withheld from the employee in respect of his contributions would be taxable to him but the employer's contributions would not be.

Split premium (dollar) insurance virtually was unknown until the issuance of Rev. Rule 55-713, 1955-2 CB 23. That ruling pertained to a compensation contract between a corporation and the president, the purpose of which was to pay disability and death benefits. It was funded by a life insurance policy over which the individual had partial control. Having that measure of control, the premiums to be paid by the corporation would have been taxable to him. The individual assumed payment of the cost of current protection and the company agreed to advance the amount equivalent to the yearly increases in cash surrender value. Upon realization of the proceeds, the employer would receive the cash surrender value and the individual's representative would collect the balance. The ruling likened the advances by the employer to an interest free loan and reached the conclusion that no taxable income resulted to the individual from such advances.

Many employers who can afford to make interest-free loans to their employees on a fully secured basis are willing to participate in a split premium plan for one or more of the following reasons:

(a) Young and promising employees are able to achieve a sense of security for their dependents because thereby they obtain a great deal more life insurance than would be possible out of after-tax dollars.

(b) Such a plan can be correlated with the build-up of an employee's interest in a pension, profit sharing of stock option plan.

(c) The insurance can be used as security for a deferred compensation agreement.

(d) Advances can be made on existing policies, thus raising the spendable income of sorely pressed individuals without materially decreasing their protection.

One obstacle to the widespread use of split premium insurance is that the cost of current protection is high in the early years of the policy. The employer may have to assist the employee with direct loans not secured by the life insurance policy so as to carry him to a point where the current cost can be met by him without assistance. Life insurance companies have developed policies with relatively high cash values in the early years of the coverage and other schemes to overcome this hurdle.

Medical Insurance.

The employer's share, if any, of premium payments for Blue Cross, Blue Shield, and similar type plans is deductible as ordinary and necessary business expenses and is non-taxable to the beneficiaries of the plan. Benefits collected are non-taxable to the employee whether the coverage is limited to him or also covers spouse and children. Like group insurance this is a highly attractive form of fringe benefit to the employee, but unlike group life it is adaptable to a few or one person. The individual who must pay medical bills from after-tax funds with the only offset being a limited deduction under Section 213 for medical expenses is in a decidedly inferior position to the beneficiary of an employer-financed insurance coverage.

There is a strong trend in the direction of high limit coverage, usually subject both to deductible and co-insurance clauses, to take care of the ruinous type of bills incident to major operations, lengthy treatment, and hospitalization. Where the plan applies only to officers and supervisory personnel it would seem that a question may arise as to reasonableness of over-all compensation in so far as the deduction is concerned, or even a contention in some instances where stockholders benefit, that the payments are really dividends.

Pension and Profit Sharing Plans—Tax Features.

If a pension plan meets the requirements for qualification set forth in the Internal Revenue Code, the employer's contributions in respect of current service cost are deductible currently, and for past service, are deductible over a minimum period of 10 years. For a profit sharing plan, there is a ceiling of 15 per cent of the compensation of those covered by the plan. However, amounts contributed in excess may be utilized as carry-overs in later years if the circumstances conform with the conditions specified in the Code. Where both a pension and a profit sharing plan are in effect in the same company the maximum deduction (including past service cost) for each year is 25 per cent of compensation. If the plan should become disqualified in a future year, the contributions would be deductible to the employer only if they become nonforfeitable to the employees in the year of contribution and would not be deductible either in that year or in any later year if vesting is deferred beyond the contribution year.

Thought must be given to the matter of reasonableness of compensation in considering the amounts credited to officers and shareholders. If there is delayed vesting, the Government is barred from adding the amount credited to the individual under the plan to the total of other forms of compensation paid to him during the contribution year in measuring reasonableness, and it appears that the Government is confined to the matter of whether the entire contribution by the company for that year is reasonable. With immediate vesting, the amount of the credit may enter into the Government's deliberations concerning the maximum allowable compensation for a highly paid individual. It may be prudent to have no vesting until retirement (this would only be possible for pension plans) where one or more officers are on the borderline in respect of total compensation. A drawback is that early retirement may be impeded.

Taxation of Benefits

Members of qualified pension and profit sharing plans are not required to include the amounts credited to them either from the company contribution or the earnings of the plan until benefits are received actually or constructively. Further, the earnings within the plan are not taxable to the plan.

In as much as the employer receives a current deduction and the corpus accumulates tax free, retirement benefits via the qualified plan route very likely will exceed the benefits made available through a non-qualified plan or by the individual through his own savings. Looking at the matter in another way, assuming that the same benefits can be provided through a qualified or a non-qualified plan, it almost certainly will be more economical to fund those benefits through a qualified plan.

There is a high potential for errors in reporting the benefits received under qualified plans. From the plan booklet distributed by the employer, the beneficiary usually can gather information about such features as life insurance coverage benefits or retirement at assumed salary levels and termination settlements. However, applicable tax sections of the Code are intricate and the employee customarily looks to the employer for help in reporting his retirement income. Following is an outline of the taxation of benefits to the employee:

(a) In general, pensions are taxed as annuities. Often the cost basis for the annuity is zero but it could include such items as life insurance premiums under the plan which have been included by the employee in taxable income, contributions to the plan by the employee, the employer's contributions of a nonforfeitable type made while the plan was nonexempt, or amounts credited to him while his compensation was exempt from tax under Section 911 of the Code.

(b) Capital gain treatment is available where the total due under the plan is paid to the employee within one year on account of separation from service.

(c) If the plan includes life insurance, the part of the employer's contribution equivalent to the cost of current protection is taxable currently to the employee. Where the employee receives a retirement income contract upon retirement, he must convert it within 60 days into a form of contract other than life insurance to be excludable under Section 101(a) of the Code or he will be taxed on the entire cash value of his interest.

For the representative of a deceased employee:

(a) The portion of the amount distributable which stems from the employer's contributions may be free from the Federal estate tax.

(b) Up to $5,000 of the total amount distributed in one year is exempt from income tax whether the interest of the decedent was forfeitable or nonforfeitable.

(1) Where paid in instalments an equivalent benefit is given in the form of an addition (maximum of $5,000) to the "investment in the contract" but this only applies to the extent of the forfeitable interest of the decedent.

(2) The exclusion does not relate to amounts received by the survivor under a joint and survivor annuity where the employee received one or more payments during his life.

(c) If the total interest of the decedent is paid within one taxable year of the payee, capital gain treatment is applicable whether or not the employee had been separated from service prior to his death.

(d) Where there is life insurance protection in the plan, with a reserve accumulation for the purpose of funding the pension and the employee dies before retirement, the amount of cash value immediately before death is not considered by the Service to be includible as the proceeds of life insurance. But the balance, or life insurance element, would be excludable under Section 101(a).

(e) Pension benefits, as distinguished from life insurance, are taxable under the general rules.

Profit Sharing vs. Pension Plans

In most types of fringe benefits, the impact of the cost of the plan on the company as a whole is comparatively small, but this is not true in relation to retirement planning, which raises a question as to whether pensions are fringe benefits. As the term is inexact and is unsatisfactory at best, we will not try to answer the query here. Virtually all large companies have retirement plans in effect. It is among the successful smaller companies that the interest in new plans exists. The point around which discussions usually orbit is whether to use a profit sharing or a pension plan.

The principal use of the qualified profit sharing provisions is to fund pensions. The Code allows the profit sharing vehicle to be used for that purpose provided the benefits are not actuarially determinable. Profit sharing plans also are used for limited term deferments. The latter is comparatively less popular because it misses the point. Tax deferment yields tax savings only if the distributions will fall in periods of curtailed income, such as after retirement. Generally speaking, there is little to be gained in periods of level tax rates from moving the compensation of one period into the income of another. Short-term deferment through profit sharing is more apt to be found among savings plans and multi-purpose plans intended to deal with such matters as supplementary unemployment benefits.

Although seemingly more attractive in times of business recession, profit sharing plans are substantially inferior to pension plans in providing for retirement. For instance, under profit sharing: (1) It is not possible to schedule benefits in advance, (2) the inclusion of past service costs is discouraged by the Internal Revenue Service, and (3) where discrimination is likely to result from forfeiture under a profit sharing plan the Service requires fairly rapid vesting and this adds to the cost when compared with certain forms of pension plans in which benefits may be forfeitable until retirement.

It was noted earlier that the employer may deduct contributions to a profit sharing plan up to a maximum of 15 per cent of the compensation of those covered. There is no comparable ceiling for pension plans. The pension plan contribution usually will be less than 15 per cent of compensation but a year's deduction can exceed that and be allowable provided it is needed to fund the plan.

Formula Requisites

In the current regulations, the Government relaxed the requirement that there be a predetermined formula for contributions under profit sharing plans. This would seem to add attractiveness to such plans because it permits the employer to have an increased degree of flexibility in accommodating its affairs to the business cycle. However, the Government is watching for abuses and will disqualify any plan which threatens to discriminate in favor of owners and officers by reason of lacking a predetermined formula. In addition, the Wage and Law Administrator has done some grumbling about the lack of a formula and companies which follow that route may have to pay overtime on the contribution.

Funding Methods

The small employer is apt to approach the matter with much apprehension because he is inclined to retain lingering doubts that the plan under consideration is really necessary and has a natural reluctance to undertake a long range commitment. It happens that the size of the company is one of the decisive factors in the pension plan area. Some of the reasons are: (a) Large companies usually have a fairly wide selection of funding media, including some with a high degree of discretion as to the amount of a given year's contribution such as deposit administration and self-administered types, but the small employer who really needs flexibility is just about restricted to the individual policy type; possible relief lies in the direction of an industry wide plan, or a common trust type of self-administered plan; (b) the flexible type plans suitable to large companies are more economical, at least in the early years of the plan, than are small company plans; for example, they permit discounts for turnover and mortality; and (c) the greater resources of the large company tend to allay concern about its ability to continue a plan during depressed periods. It is doubtful that Congress intended such a discriminatory result in enacting the pension plan sections.

The currently popular deposit administration and self administered pension plans may be so set up that the amount of the yearly contribution in respect of current service is discretionary within an allowable dollar range rather than confined to a set figure. This dollar range is developed yearly by the actuary in the form of the upper and lower limits applicable to that year's contributions. One possible advantage to the ability to vary contributions from year to year is that larger than average deductions may be taken in high tax rate years. The responsibility of the employer must be met ultimately, so much that is accomplished in the name of flexibility is only a postponement. Nevertheless, by deferring deductions to later years a real saving may result in the event of a rate increase such as another excess profits tax law. In evaluating these possibilities, it is important to distinguish between currently deductible and past service cost. For example, a make-good for an earlier year in which the contribution was below the lower limit set forth by the actuary most likely would have to be amortized over a future 10-year period.

Observations about particular plan types are for purposes of illustration. It would be unwise to attempt to generalize about the advantages of one type of funding over another because every plan should be custom tailored to the particular needs of the employer and its personnel. It is even dangerous to use the descriptive terminology of pension plans as we have done above, since combining the basic characteristics of two types of plans has been resorted to where the circumstances necessitated.

Life Insurance, etc., in Pension Plans

Careful study should be given to such features as life insurance, termination allowances, disability, and early retirement to cope with the problems presented. From a tax standpoint, group life insurance has several advantages over the same amount of coverage through a pension plan. In conventional group life plans no part of the premium payments by the employer results in taxable income to the employee, and on death, the proceeds are not subject to income tax. When included in a pension plan the equivalent of the term insurance premiums is taxable currently to the employee and the pension reserve portion may be subject to tax as ordinary income upon collection of the proceeds at death before retirement, except for the $5,000 death benefit exclusion. Under some pension funding methods, life insurance coverage is essential but its tax disadvantages should be recognized.

Deposit administration, self-administered plans, and some types of group annuities are more likely to omit benefits for those employees who die or leave the company prior to retirement age. Obviously, elimination of such benefits will result in cost savings.

Conversion of Obsolete Plans

It is possible to convert a profit sharing or pension plan which has become obsolete into a modern type pension plan. As a rule the conversion is complicated and requires careful draftsmanship. The Internal Revenue Service holds that there must be full vesting of all previously forfeitable credits at the date of terminating the old plan. The amount thus vested is the equivalent of funding the past service cost of a new plan. If the new pension plan provides for termination benefits prior to retirement, this probably would not be a material cost factor, but if the benefits are limited to pensions for those still in the employ at retirement age, a part of the amount thus vested is a loss factor.

Savings Plans

Savings or thrift plans are popular among large corporations. Care should be exercised to ensure that such plans are qualified as profit sharing plans otherwise the employer is likely to lose its deduction unless its contributions vest during the taxable year when made. This is the only type of qualified plan that always is contributory on the part of the employee. The employer agrees to contribute to the fund a given percentage of the amount deposited by the employee. Such contribution is deductible by the employer (assuming that the plan is qualified), but is not taxable to the employee until paid or made available to him.

Frequently, various investment options are offered to the employee, one of which may be to invest in the employer's securities. In those cases where the employee's contributions are placed in his company's securities, the investment is treated for tax purposes as though made directly by the employee, that is, no gain or loss is recognized on withdrawal of the securities from the plan. With respect to employer's (including parent or subsidiary) securities purchased with the company's contributions, which are distributed in kind, the market value of the securities is taxed as ordinary income to the employee, unless the entire interest is taken out in one year and is coupled with termination of employment. In the latter event, any appreciation is excluded from income until the securities are sold, at which time, long-term capital gain treatment applies. These comments apply equally to other types of qualified plans which have investments in the employer's securities.

Supplementary Unemployment Benefits

One of the collateral uses for profit sharing plans is as a substitute for a supplemental unemployment benefits (layoff) plan. However, this cannot be the principal or only purpose of a profit sharing plan, otherwise it will not qualify under Section 401. The automobile manufacturers and similar SUB plans are not qualified plans although they may obtain an exempt status under Section 501(c) and contributions thereto are deductible under Section 162 of the Code rather than under Subchapter D. The straight SUB plans provide for fixed contributions per hour or other unit of measurement as contrasted with a profit sharing plan where the contribution normally would be based upon profits. Knowing that those who rank low in seniority stand to collect benefits under an SUB plan, the employees with seniority are not enthusiastic about them. The employer with a profit sharing plan permitting distributions, or even loans, on the occasion of a layoff may be in a strong position in collective bargaining concerning SUB plans.

Stock Options

A large part of the glamour in the fringe benefit area emanates from the stock option, at least during bull markets. Through it, a selected group of officers and employees get a free ride as there is nothing in the Code prohibiting discrimination against any employee group. If the stock increases in value in relation to the option price, the optionee may move in and make his purchase at the option price, whereas, a shareholder would be subject to market risks during the same period. Two major problems confront the option holder. One is the income tax and the other is the matter of financing the purchase. As they tend to become interrelated we are concerned with both. For purposes of this brief discussion, it is assumed that the optionee still is in the employ of the corporation which granted the option or of its parent or a subsidiary. If the option arrangement conforms in all essential respects with the rules laid down by Congress for restricted stock options, there are no tax problems until the option is exercised and the stock is about to be sold. Provided that sale of the option stock does not occur within two years from the date the option was granted or within six months after the option was exercised, and assuming that the option price was 95 per cent or more of market value at the time the option was granted, any profit on that sale will be long-term capital gain; if the value was between 85 per cent and 95 per cent of the market value, an ordinary income element may be present.

Financing problems take away much of the attractiveness of restricted stock options because the minimum option price of 85 per cent or more of the market value on the day the option is issued will be beyond the means of many optionees. That is true even though the option price proves to be a genuine bargain at the date of exercise. Often it becomes necessary to sell a substantial part of the option stock right after the six month holding period expires, thus tending to thwart the usual purpose of the plan which is to give the optionee an equity interest in the business. Bank loan restrictions usually bar long-term financing, and loans from the employer may not be the answer for any one of several reasons.

If a plan cannot achieve the status of a restricted stock option, tax problems become of paramount importance. It is unsafe for many companies to offer stock options because, lacking an active market for their shares, there can be no assurance that the option is at least 85 per cent of the market value. If such a company were to try and fail, Section 421 is so constructed that all protection would be lost and the optionee would receive the same tax treatment as though Section 421 had been ignored in the first instance. As a result, the optionee would have ordinary income measured by the difference between the option price and the market value at the purchase date.

Many individuals have options which lack a present value because of stock market decline. If the option price can be decreased sufficiently, such option would become valuable. Modification, extension, or renewal of restricted stock options generally is inhibited by the Code. There is one exception. Where the average fair market value of the option stock for the 12 consecutive calendar months preceding the month of modification, etc., is less than 80 per cent of the fair market value on the date of granting the option, the price (and other features) may be changed. Assume a restricted stock option was granted on January 2, 1957 to buy 100 shares before July 1, 1958 at 85 per cent of its market value on January 2, 1957 of $100 per share. The average market value from May, 1957 to April 1958, inclusive, was $70 per share. Accordingly, the option may be extended to a point beyond July 1, 1958 and the new offering price could be as low as $59.50. A modification, extension, or renewal is considered to be the granting of a new option. As stock option plans usually required stockholder approval, non-tax problems may be presented by such changes.

Companies which have restricted stock options outstanding should be alert to the possibilities of obtaining a deduction in respect of disqualifying dispositions. When an employee sells his option shares either within 2 years after the option was granted or earlier than 6 months after exercise, a deduction accrues to the employer measured by the difference between the option price and the market value of the stock on the date on which the option was exercised. As this deduction will not appear in the company's accounts, only alertness will bring it to fruition as a saving to the employer. The spread in non-restricted stock options also gives rise to a deduction as of the date of exercise.

Deferred Compensation Contracts

As with most other fringe benefits the size of the employer tends to be material in the drafting of non-qualified deferred compensation arrangements. The latter term is used here in a limited sense to denote contracts with executives who agree that upon retirement they shall refrain from competing with the present employer, act as a consultant after retirement, and in return are to receive periodic compensation payments. The basic reason for such plans is to soften the attrition of high surtaxes, since, at least in theory, the corporation pays no higher amount for the executive's services, the pay-out period merely being lengthened.

To date, well drafted agreements covering executives of the larger companies seem to have been immune from Government attack. However, until the ruling of the Tax Court in the Casale case was reversed by the Second Circuit there was genuine concern about the type of plan characteristic of smaller companies. The executive of the large company usually is satisfied to have the credit of that company as security for the fulfillment of its commitment. Obviously, that would be less than satisfactory for small company executives, so they have turned to life insurance for collateral. Such a plan was at issue in Casale where the Tax Court, after noting that Mr. Casale owned 98 per cent of the stock and was chairman of the board, president, and treasurer, concluded that it was justified in disregarding the corporate entity. Under its decision the life insurance premiums paid by the corporation would have been taxed to Mr. Casale. The Second Circuit, reversing, reasoned that the policy was the property of the corporation, as such was subject to claims of creditors and hence Casale was not in constructive receipt of any dividends. The fact that the life insurance policy was security for the company's promise to make payments to a 98 per cent shareholder did not alter the Court's thinking, because any interest Casale had in that policy was contingent.

Deferred Compensation Contracts—Drawbacks

In the conventional type of contract the individual agrees to perform consulting services for his company after retirement. It is not clear yet as to whether the holding of oneself available as a consultant would be inconsistent with "separation from service." Without "separation from service" capital gain would not be available as a lump sum distribution from a pension or profit sharing plan. This may be sufficient reason for omission of the consulting service requirement where the other conditions and contingencies are sufficient to avoid constructive receipt.

Most individuals who receive deferred compensation contracts think of the build-up under the plan as part of their compensation for current services. However, where they also are members of a qualified profit sharing plan the build-up under a non-qualified deferred compensation contract would not be included in his total compensation for purposes of spreading the company's contribution. Thus, the amount credited to him under the profit sharing plan would be less than if he had taken the additional compensation in the form of cash. Similarly, the build-up under the deferred compensation contract cannot be used in measuring pension benefits upon retirement.

These are comparatively mild disadvantages but it may be well to draw them to the attention of the interested parties.

Other Fringe Benefits

The miscellaneous area covers a wide range including travel and entertainment allowances in excess of amounts actually expended on business, personal use of company equipment such as automobiles, airplanes, yachts, and apartments, vacation trips in the guise of business travel, personal club dues and charges at company expense, etc. In many instances the amounts involved are inconsequential and defy detection. Even substantial benefits frequently are difficult for the examining agent to discern. One psychological factor in this picture, which fosters a loose attitude on the part of businessmen, is the tendency among legislators and others in Government service to arrange fringe benefits for themselves.

The U. S. Supreme Court (Smith v Com'r 324 US 177) held that the definition of gross income contained in the Code is ". . . broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected. As benefits such as those mentioned in the previous paragraph are not excluded from gross income anywhere in the Code, they are properly includible in the tax base. Even though such items do not have the blessing of the law, they confer the same tax advantage on the recipient as though they had. One possible drawback, which is too new to appraise in terms of over-all effectiveness, is the policy of the Internal Revenue Service to disallow deductions in respect of benefits to stockholders on the ground that the benefits are constructive dividends. This bites deep because the result can be a combined tax cost to company and employee of well over 100 per cent of the income involved. One of the characteristics of these off-beat benefits is that they nearly always are confined to a relatively small group and hence are likely to be less costly to the employer than bona fide plans, most of which require numerically broad coverage.

There is not much to be added to this intrinsically difficult topic. Undercover practices, while clearly the progeny of high tax rates, are a blot on the reputation of businessmen in general. Experience under our and foreign tax laws leads one to be pessimistic about the prospects for severely curtailing the abuses. However honest this spirit of pessimism may be, it is inclined to promote a cynical outlook which, in turn, is a step in the direction of an eventual breakdown of our revenue collecting system.

INTERNAL REVENUE SERVICE TECHNICIANS: YESTERDAY AND TOMORROW

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The subject, "Internal Revenue Service Technicians: Yesterday and Tomorrow," was assigned to me on the assumption that the first two speakers would have reached your saturation point with regard to technical information, and that you might now be interested in the more relaxing impressions of an outsider with reference to differences to be anticipated in future years in the professional quality and technical competence of those technicians in the Service with whom you have the most frequent contact.

Consideration of the probability that you will encounter more talented technicians in the future requires us to explore the reasons why, and the extent to which, the Internal Revenue Service has found it necessary to develop, and the way in which it has shaped, a newly designed training program for recruits to its technical force, so as to complement that training which those recruits previously received in schools of Business Administration.

At the outset, I should identify the class of technicians about which the Service was primarily concerned, and the reason for its concern.

The presence of a former Assistant Commissioner (Technical), Mr. Sugarman, is only one of the reasons why I should hasten to exclude from the class under consideration those technicians who are associated with his office. The fact is that the most serious technical training problem which confronted the Service related to the Audit Division's Revenue Agents, of whom some 500 new men come on board each year.

These men presented the Service with its most serious problem for two reasons.

The first looks to the future. The Service, and particularly the Audit Division, is in-bred to a very high degree, and perhaps necessarily so. In any event, it is from the Revenue Agents that the Service eventually draws the bulk of its Reviewers, Group Supervisors or Informal Conferees, and many of the members of its Appellate Division, all of whom are charged with the responsibility of resolving highly technical and complicated questions. If, after the passage only of time, agents are to be lodged into such key slots, their earlier professional life should have been so arranged that their previous work-a-day world experiences—a type of self education—

would be productive of a truly enriched professional technical understanding. The chance that this will be so will be greatly enhanced if their formal classroom training is initiated as they enter upon their Revenue Agent's assignments, provided that program is shaped so as to produce initially the kind of technical understanding which will most effectively ripen with experience.

The second and more immediate reason why Revenue Agents as a class present the Service with a serious training problem has to do with the many sophisticated skills which these men must have as agents if the tax laws are to be enforced properly. There are few other places in the government's technical services where the proper fulfillment of a position demands so many diverse, complex professional qualities. In the main, the government's response to the problem must be to expend the bulk of its training dollar on those facets of a good agent's complex professional complexion which were more or less ignored, perhaps necessarily so, within the confines of a four-year course in Business Administration.

On the one hand, the well qualified agent must understand the complex accounting systems used by modern business. Here, through a requirement that each recruit have the equivalent of 24 college hours of accounting—which normally would include some auditing, the government can and does rely heavily on the academic foundations provided by schools of Business Administration. But while the agent will make use of his academic training in accounting, he must be given additional formal training in a complimentary skill, i.e., in those different examining techniques which are deemed by the National Office to be appropriate to the work of the Service even in the instance where the examination concerns a properly kept set of records. Possession of even this double-barrelled examining skill will still leave the agent short of satisfying the demands of his job. This is so in part because an agent actually examines, more or less, the "whole" taxpayer, not just the records relating to his business. This means, among other things, that he must be given some formal training in the way to respond to the non-recorded side of the taxpayer's activities, a problem not essentially different from the case where a single proprietorship or small corporation presents him with a set of wholly inadequate records—a type of situation usually ignored by typical collegiate auditing courses. Because of the agent's ultimate responsibility on the civil side, he must then be developed into something of an investigator. This required skill also has significance on the criminal side, for if the agent fails to recognize the symptoms of fraudulent conduct on the part of a given taxpayer, it will remain undetected.

Finally, it must be remembered that the agent's examination in every case is for a purpose beyond determining the accuracy with which the taxpayer's records reflect the facts. If he is to accomplish his ultimate goal on the civil side, he must be trained to understand in a truly professional way, i.e., be able to interpret and apply with real professional skill, the most complex law ever designed by man—a law so complex that it has been divided, then sub-divided and re-divided, simmering down finally into about 2,000 sections which use approximately 200,000 tightly knit words in spreading the tax message across 929 pages. One would be mistaken to assume that simplicity results from this obvious effort at precision, for the fact is that the total number of different words in the English language is relatively small, with the consequence that many of its words reflect varying degrees and various shares of meaning. And this means that a good share of those 200,000 statutory words in the Code raise interpretative difficulties, a fact attested by the present existence of 36 volumes of published administrative rulings, 75 volumes consolidating the 110,000 pages of reports from the Tax Court and Board of Tax Appeals, and some 50 volumes consolidating the tax reports of other courts. To this assortment of tax lore one should, of course, add the explanatory Regulations which, to the extent now finalized, would, if published in the format of the Tax Law Review, run to another 3,000 pages.

From the foregoing one can readily see that it is one thing for an Assistant Commissioner (Technical) to assign and train a new man to do initial spadework on rulings which relate just to sick pay. It is quite another to put in the field a new revenue agent who must be capable of recognizing and resolving issues which may span across any one of hundreds of provisions in the Internal Revenue Code. No one, of course, could ever hope to have all of the answers to the whole of this vast subject on his finger tips, so the agent must also be trained to research, effectively and quickly the tax questions about which he is uncertain. But on the assumption that the agent can always look up the answer, one should not lightly dismiss the agent's need in the first instance for a really professional-like understanding of the Code. At a minimum, across the board, he must be richly endowed with what I call "issue awareness," which means that an agent's understanding of tax lore must be such that he will recognize a statutory issue when it is involved in a set of facts, for only such recognition will lead him into the books. On the other hand, he cannot do his job effectively if, through too limited knowledge, he has to spend a major share of his time in his office acting like a lawyer, researching every single matter that might come up.

In connection with his need to become something of an artist in tax research, it must also be remembered that whereas some taxpayer's representatives may conclude their effort after finding just one case which suggests that there is some favorable ground on which to rely—and, e.g., on this basis take a deduction, the agent, when confronting such situations, should press on beyond that one case and learn to draw neat lines which emerge from synthesizing what may turn out to be competing primary legal materials both proximate and remote in terms of possible applicability.

It should be apparent from the foregoing that the work of a Revenue Agent calls for skills and talents on many sophisticated fronts, not just one. For reasons to be noted later, no four year collegiate program in America provides, or could provide, satisfactory training on all of these matters. It was encumbent on the Service to step in if high quality in performance was to be the goal.

Mr. Harrington responded to the problem by appointing a three-man committee consisting (1) of a partner in a national accounting firm, (2) one of the most progressive of his District Directors (also a C.P.A.), and (3) myself, assigning to us the task of developing detailed recommendations regarding the specifics of a training program for all agents.

After spending a summer analyzing all of the materials and programs then existing, a questionnaire over Mr. Harrington's signature was sent to every District Director and Regional Commissioner asking that they obtain a cross section of views at all levels suggesting the specifies which they would recommend for an agent's training program. After cataloging and analyzing those voluminous written replies, each member of the Committee then personally interviewed dozens of people of various grades in scattered districts, those interviewed running from persons who had been a Revenue Agent for one month, three months, one year to Group Supervisors, Chiefs of Audit, members of the Appellate Staff, etc. On the oft proved assumption that many good ideas originate in other lands, the Committee then addressed detailed questionnaires to Sir Henry Hancock, Chairman of Britain's Board of Inland Revenue and to Mr. James J. McCann, head of the Canadian Department of National Revenue. Their detailed replies and companion documents were carefully studied in an effort to determine to what extent, if any, British and Canadian methods of in-Service training would be useful here.

Finally, the directors of the Training and Audit Divisions in Washington, and their staffs, spent a number of days with us, contributing many ideas. From the host of ideas thus contributed, the final product emerged.

The first facet of that product had to do with the agent's understanding of the tax law itself.

Our fact finding study revealed that most of the recruits into the Service from the schools of Business Administration had never seen, much less studied directly from, a copy of the Internal Revenue Code itself. While many professionals indicated the view that the Code should be the working day-to-day "Bible" of any good tax man who plans to mold a career in this field, most of the recruits were not even familiar with its general arrangement. Nor had they come into intimate contact with a copy of the Treasury Regulations or other administrative rulings. Again, for obvious reasons, they were woefully weak in the skill of analyzing and fixing the perimeter of a tax case decided by the judiciary, to say nothing of the ability to synthesize several closely related but seemingly competing decisions.

In short, the study tools of most of them had not included any of the primary raw data which makes up the body of the tax law itself, and yet it would be with just such unfamiliar legal raw data, among other things, that they would be concerned during their careers as agents. Most of the recruits had studied from loose leaf text books written about the tax law, and in the language of laymen. And these tended to set forth a galaxy of firm rules, i.e., seemingly fixed end results, along with illustrations bearing on "black" or "white" situations, giving the student the impression that the law on a given set of facts was almost always quite predictable.

Our committee, composed—I repeat—of a practicing C.P.A., a District Director of long experience who was also a C.P.A., and a lawyer, concluded that a deeper, more professional-like understanding, one upon which experience could most effectively build, would be derived:

(1) from a careful study of the statutory language—in the setting of the Code itself;

(2) from an acquaintance with the asserted reasons which led congressional committees to shape each fundamental statutory section in a specific way;

(3) from an opportunity to fiddle, in the light of primary or raw interpretative materials, with a host of the interpretative difficulties which can be encountered in applying the statutory language; and

(4) from processing a number of problems through the various tax services, so that the agent would have a thorough understanding of their structure, their shortcomings, and of the various methods

by which one can process questions through them, bringing any findings down to date. To emphasize this, I repeat that the agent must necessarily be his own lawyer, for no other is available to him on a day-to-day basis.

We concluded that such a formal study program could, more nearly than other alternatives, endow an agent with the kind of flexible understanding essential to his development of an acute sense of issue awareness and convert him into a more skeptical reader of primary tax materials. In other words, it would, for example, make him aware that a word in the Code may cover a host of matters beyond the obvious, or that a decision in one narrow corridor may or may not have implications in another. And in this way we hoped also to sharpen his ability to analogize from problems the answer to which he knows or can find to somewhat similar problems the answer to which he does not know and cannot find. And it must be remembered, in this connection, that while two problems may look somewhat alike, the possibility of carrying a known result of one over to the other depends upon the particular reason behind the known result as well as upon the degree of similarity in the appearance of the two problems. In short, a deep professional-like understanding of the tax law is indispensible to the process of drawing analogies.

To meet these needs, two separate programs in tax law were designed, the first to be offered to the agent immediately upon the commencement of his association with the Service. The second follows two years later, at that point in his career when the type of returns assigned to him for examination assume much greater complexity.

However, the methodology of the two is the same.

In the first program, the agent's study of the substance of the law absorbs 176 classroom hours, for each of which appropriate extra study time is allowed. This amount of classroom time exceeds that expended in five different typical three credit-hour collegiate courses bearing on tax matters.

The student recruited into this program is initially given three volumes, one being a copy of the Internal Revenue Code. A second volume consists of a great many carefully designed short hypothetical statements of fact arranged in sensible sequence under appropriate sub-topic headings. Under each such heading, these hypotheticals, with cross references over to the Code and to a third volume I shall describe, are further arranged so as to move from situations which call for an obvious result under the language of a given section of the Code to those which involve varying degrees of interpretative difficulty.

The third volume is a specially designed loose leaf reference work arranged under the same sub-topic headings as the hypothetical situations in the second volume. Under each sub-topic heading, the reference volume sets forth four types of materials. First, is an extract from the report of that congressional committee which gave birth to the pivotal language of the statutory section in question. To obtain these, one could not just look to those reports from the House Ways and Means and Senate Finance Committees which accompanied the adoption of the 1954 Code. As you know, much of the really pivotal language in that Code had its origin in Revenue Acts of a much earlier day. Accordingly, if we really wanted the agent to understand the practical circumstances that led Congress originally to adopt certain key language, and to appreciate what Congress hoped thereby to accomplish, it was necessary to include extracts from a host of early committee reports.

The extract which explains why a given section or sub-section of the Code was shaped in a given way is then followed by the statements of facts and extracts from relevant court decisions and administrative rulings. In the main, an effort was made to include in these latter extracts that part, e.g., of a court decision, which indicated the reason why that section of the Code was being construed as it was, thus furnishing him with a more effective basis from which to draw analogies.

In general, the series of extracts with appropriate connecting links in text form will roughly fix the perimeter or circumference around the fundamental types of problems controlled by each particular basic section of the Code.

In the course of analyzing the hypothetical fact situations during his study period, the student tries to apply the language of the Code itself in light of the reason which led to the adoption of the particular section in question, and in further light of the reasoning and results which appeared in the verbatim extracts from decisions and rulings.

Those hypothetical situations are then discussed in class in the light of the primary or raw interpretative materials just mentioned. The aim, as you can see, is to make the Code itself, in the eyes of the recruit, a living document to such a degree that he feels comfortable in toying with its technical jargon, and has a framework of understanding essential to the recognition of issues and to the process of drawing analogies from one situation to another.

Toward the conclusion of this course in substantive tax law, a set of each of last year's editions of the major tax services are put between each two students. After walking the students through the structure of a particular set, the instructor then processes a number of hypothetical sets of facts through each set, the problems being designed to bring out all of the various advantages and shortcomings of a given publication. The students are then required to process through those same sets a series of different hypothetical situations.

The first course on tax law is to be followed two years later by another consisting of 60 classroom hours during which, using the same method, the most complex problems relating to corporations will be emphasized.

Methodology-wise, somewhat similar classroom courses for specialists have or are being designed to accommodate the peculiar needs of agents who work, e.g., in the excise tax field, in estate and gift taxation, or in connection with pension trusts.

Equally important as the question of whether and how to establish a special course in tax law was the further question of whether and how to initiate a classroom course in the special examining techniques expected of Revenue Agents.

You may or may not think that the methods employed by agents should or should not differ from those of the Certified Public Accountant who is conducting an audit. But it was not our job to quarrel over this latter question.

The first question before us, whether to have a special classroom course in the Service's examining techniques, involved two competing considerations. In the absence of a classroom course of some kind, the 500 new agents recruited each year would receive training in this skill only on an on-the-job training basis, and presumably since their 500 different trainors would also not have received any classroom training on the subject, the types of examination procedures would suffer untold and perhaps unsound variations.

On the other hand, it is not easy to teach examining techniques in the classroom, and when the attempt is made, one runs the risk of unduly stereotyping the methods of examination. Because of these competing difficulties, no solution would be wholly soul satisfying.

Our proposed solution was to utilize the problem method in a rather ultimate sense.

While no effort will be made in the classroom to cover the whole terrain of factual possibilities, the problems were given varied designs so as to reflect the typical types of taxpayers the agent would confront, e.g., a professional man, a proprietorship involving a retail establishment, a small incorporated factory, etc. In the setting of a specific problem, the student would be given certain elementary facts and the records of the taxpayer even to the extent, for example, of the cancelled checks, vouchers, etc. Following a discussion among the students as to the first step which should be taken, the instructor sums up the alternatives, indicating advantages and disadvantages, and then by mutual consent they proceed down a given avenue. Shortly some student will arrive at a point where he will say that he needs added information, at which point the instructor pulls out a mimeographed sheet which reflects the information that student needed. This will be repeated at many stages in the problem. Occasionally, of course, a student will say he needs information when in fact the information would not really assist him, but to accommodate his request, an attempt has been made in advance to think out answers which the instructor will give him.

As one phase of an examination is completed, again there will be discussion of the alternatives with reference to the next step which might be taken.

By preparing the problems at the National Office level, it was hoped that its views with reference to appropriate alternatives might be brought to bear on the recruit, it being emphasized all the while that its proposed steps are by way of example only, and that with possible and even suggested factual variations, the student might well consider taking a different step. This classroom course will then be complemented by an organized on-the-job training stint during which care will be taken to see that this training experience will run the gamut of the types of returns the recruit will be examining in the years immediately ahead.

There are, of course, other facets of the formal classroom training course. While such matters as the rules of conduct governing an agent, the matter of his public relations, and his understanding of the way in which returns are processed and of the manner in which he should prepare his reports are important in his professional life, they did not present peculiar training difficulties which would be of interest to you.

In the end, we can only hope that a training program has now been established which, when coupled with experience, will yield a higher quality professional tax man even more deserving and capable of growing into the various position opportunities available in the Service.

SIXTH SESSION

FRIDAY, MAY 16, 1958—12:30 P.M.
The Ohio Union—West Ballroom

Presiding:

WILLIAM R. DAVIES, *President, The Institute of Internal Auditors; Director, Audit Division, U. S. Steel Corporation, Pittsburgh*

Presentation of Hermann C. Miller Memorial Scholarship

RUDOLF BAUHOF, *President, The Ohio Society of Certified Public Accountants*, making the presentation to:

WILLIAM J. SERRAINO, *Instructor, Accounting Department, The Ohio State University, Columbus*

Paper: "Evolutionary Changes in Auditing in the Federal Government"

WILLIAM A. NEWMAN, JR., *President, Federal Government Accountants Association; Deputy Director, Defense Accounting and Auditing Division; General Accounting Office, Washington, D.C.*

EVOLUTIONARY CHANGES IN AUDITING IN THE FEDERAL GOVERNMENT

By William A. Newman, Jr.
President, Federal Government Accountants Association;
Deputy Director, Defense Accounting and Auditing Division
United States General Accounting Office
Washington, D.C.

I appreciate the opportunity to participate in the Twentieth Annual Ohio State University Institute on Accounting, and to have the privilege of telling you something about auditing in the Federal Government as it exists today, and the changes in concepts, policies, and practices that have taken place during the past few years.

U. S. General Accounting Office

To understand any discussion of auditing in the Federal Government it is necessary first to know something about the United States General Accounting Office—its position in the Government's organizational structure and its responsibilities. This Office, which for convenience I shall refer to as GAO, was created by the Budget and Accounting Act of 1921 to make an independent audit of Government expenditures. GAO is an independent, nonpolitical, nonpartisan agency responsible only to the Congress. The Comptroller General of the United States is the head of the GAO and as such is the chief auditor for the Federal Government. He is appointed by the President of the United States with the advice and consent of the Senate for a term of 15 years, cannot be reappointed, and is removable from office only by action of the Congress. He is thus in the best possible position to insure complete independence of judgment and decision. The present incumbent, Mr. Joseph Campbell, a certified public accountant, was appointed on December 14, 1954. This is the first time that a CPA has been Comptroller General of the United States.

The 1921 act provides that "The Comptroller General shall investigate, at the seat of Government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds . . . ." His authority was clarified in subsequent legislation, particularly in the 1950 act which provides as a matter of policy that: "The auditing for the Government, conducted by the Comptroller General of the United States as an agent for the Congress be directed at determining the extent to which accounting and related reporting fulfill the purposes specified, financial transactions have been consummated in accordance with laws, regulations or other legal requirements, and adequate internal financial control over operations is exercised, and afford an effective basis for the settlement of accounts of accountable officers."

Also, the 1950 act provided for numerous improvements in the Federal Government's accounting systems; directed the Comptroller General to prescribe principles, standards and related requirements for accounting to be observed by each agency; and directed the Comptroller General to audit the financial transactions of each executive, legislative, and judicial agency of the Government with due regard to generally accepted principles of auditing including consideration of the effectiveness of accounting organizations and systems, internal audit and control and related administrative practices.

GAO's auditing responsibilities constitute a truly monumental task from any viewpoint. Its job can be measured roughly by recent Federal budgets, amounting to more than $70 billion annually, and the world-wide scope and diversity of the Government's activities. In addition to typical Government activities such as collection of taxes, management of monetary resources and the public debt, and management of the public domain, the Federal Government is engaged in some fashion in practically every imaginable type of business including railroads, steamship lines, electric power and other utilities, communications, airlines, lumbering and milling operations, insurance, mortgage companies, banking, lending operations, manufacturing, shipbuilding and repair, aircraft and automotive maintenance and repair, retail stores, research and development, and many others. The Department of Defense alone, which represents more than half of the budget expenditures, encompasses an amazing variety of business-type activities.

In many respects GAO's audit methods are comparable to those of a large public accounting organization. In addition to its headquarters office in Washington, it has 25 regional and branch offices in principal cities of the United States, and foreign offices in Paris, London, Frankfurt, Rome, Madrid, and Tokyo. It has a staff of 1,600 professional accountants of whom more than 400 are CPA's. Since 1955 nearly 500 college graduates have been recruited for its staff of professional accountants and auditors.

At your eighteenth annual Institute on Accounting in 1956, Mr. Karney A. Brasfield, who was then Assistant to the Comptroller General of the United States and President of the Federal Government Accountants Association, spoke about GAO's legislative and historical background and the basic changes in the audit approach and program from the date of its creation to 1956. Today I will tell you of the major changes in GAO's audit approach and program during the last two years.

In March 1956 the Comptroller General established the Defense Accounting and Auditing Division to expand the audit work in the Department of Defense and its military departments. At that time audit work in the defense area consisted primarily of comprehensive audits of industrial fund activities (separate accounting entities like shipyards, arsenals and the Military Sea Transportation Service), installation examinations, defense contract audits, site audits of civilian pay, the centralized audit of vouchers including military pay and allowances, and the settlement of disbursing officers' accounts. These types of audits, with significant improvements, have been continued. It appears likely that the audit of pay and allowances of military personnel may best be continued indefinitely on a centralized basis.

Expansion of Program for Audit of Defense Activities

Since 1956 the major expansion of the GAO program for the audit of defense activities has been in the areas of procurement, supply management functions and operations, contract administration and contractor operations, and military assistance to foreign countries. Many of the Department of Defense activities are of such a nature that the audit work, to be most effective, must be geared to a defense-wide approach. The review of defense-wide activities is accomplished by work programs that encompass activities at the Department of Defense level as well as activities conducted by the respective military departments. At the military department level the review of activities is made on a command or organizational basis, such as the procurement of the B-52 bomber for the Air Force. In some cases reviews of activities on a commodity basis, such as the Jet Engine Program, may involve two of the military departments.

Emphasis in these areas required the development of a program to review and evaluate the management controls relating to programming, budgeting, operating performance, accounting and reporting. The general objective of the program is to determine how the management discharges its financial responsibilities. The scope of the work required by the program involves a review of activities, determination of related policies and conformance with authorizing legislation, review of procedures and their effectiveness, evaluation of internal audits and independent surveys, and examination of pertinent records and transactions to determine the adequacy of the related system of management controls. These reviews and evaluations are similar in many respects to those of management surveys made by public accounting and engineering firms.

Review and Evaluation of Military Assistance Program

An example of the type of reviews and evaluations that are being made under these newly developed programs is a review made in 1957 of the military assistance program as administered by the Department of Defense.

Under the military assistance program the United States provides equipment, supplies, and services on a grant or reimbursable basis to other friendly nations and to international organizations. The purpose of this assistance is to promote the foreign policy, security, and general welfare of the United States and to facilitate the effective participation of such nations in arrangements for individual and collective self-defense. The Congress has appropriated more than $25 billion for the military assistance program through fiscal year 1958. The President has requested an additional appropriation of about $2 billion for the 1959 fiscal year.

This review and evaluation included an examination of (1) programming in all its stages, i.e., the determination of material requirements by the military assistance advisory groups in France, Germany, Italy, Japan, Korea, Pakistan, Spain, Taiwan, and Turkey, their review by the unified military commands, at Department of Defense level and in the Army and Air Force, and the determination of program adjustments based on budget limitations, programming criteria, and force goals; (2) supply, storage, and shipment of end items from excess, reserves, or offshore procurement; (3) the control over receipt and utilization of material; (4) the determination, recovery and redistribution of excesses; and (5) costs and pricing.

The results of GAO's examination were summarized in testimony before the House Foreign Affairs Committee in June 1957, were reported to the Congress in August 1957, and were the subject of extensive hearings in February 1958. In discussing this report, I want to emphasize that the work and assistance that GAO renders to the Congress, the Executive Branch, and the taxpayer, concerns only the administration of the program, and in no way involves an evaluation of basic mutual security program policies or concepts. GAO recognizes that much of the material with which it is dealing: records, reports, and other documentary matter, is affected by military, political or economic considerations or decisions which it does not attempt to evaluate. These are strictly policy matters for determination by the Congress and the President. However, GAO endeavors to point out the existence of such considerations, the extent to which they are involved in fundamental programming decisions, and the significance or possible consequences of actions taken.

Here are four of the basic findings and recommendations in the report on the military assistance program:

1. The military force objectives approved as programming guides for United States support in certain allied countries are not always realistic in terms of recipient country manpower and financial capabilities, are not always mutually acceptable to the countries concerned, and are not always motivated by military considerations. In addition, these objectives are fiscally infeasible in that they cannot be achieved with the funds appropriated on an annual basis. Therefore, they require refinement through the application of a sound priority order to be useful guides for programming military assistance.

GAO recommended that the Secretary of Defense review and re-establish approved force objectives after giving full consideration to recipient country capabilities, United States purposes, and the priorities of desired accomplishments.

2. No estimates had been developed of the aggregate long-range costs of equipping, maintaining and modernizing Allied military forces or otherwise achieving U. S. objectives in the countries being supported, although studies have been made in selected countries.

GAO recommended that estimates be developed of the costs required to achieve approved force objectives in each country and on a worldwide basis and that these estimates provide:

a. A basis for bringing into balance United States objectives and the United States capability to finance worldwide the buildup and maintenance of such objectives.

b. A basis for long-range program planning.

c. A framework for negotiations to achieve maximum country contributions.

d. Standards of accomplishment to be met during the remainder of the program.

e. Support for authorization and appropriation requests, which should show long-range costs, the portion already funded, the portion requiring funds in the budget year, and the time-phased costs for carrying out the remainder of the program.

3. In a number of countries the United States has programmed and was delivering military equipment in excess of that which could be effective-

ly absorbed and utilized by the recipients at their existing stage of development. The recipients either have not been able to use the aid furnished because of their financial and economic incapacity and their manpower limitations or they have not desired to use the assistance for the purposes intended by the United States. One factor that contributed to this situation had been the failure of overseas officials to follow or interpret in a reasonable manner Defense programming guidance. Responsibilities for controlling overseas agencies and for developing program requirements within the Department of Defense had not been clearly defined. GAO noted a diffusion of responsibility for programming and an uncertainty over the method of processing the program submissions of overseas agencies within the Department of Defense.

GAO pointed out that, in its opinion, increased efforts must be made to develop annual requirements on an austere basis within the demonstrated capability and willingness of the recipients. GAO recommended that the programming responsibilities of the various agencies within the Department of Defense be clarified.

4. The military assistance program had never been subject to a systematic and continuous internal audit and management review.

GAO recommended that an internal audit program be established.

Defense officials are generally in accord with GAO's recommendations and have already instituted action in a number of areas, designed to effect improvements in these areas. Some of these recommendations, however, involve consideration and determinations by the Secretary of State, National Security Council, or the President, as well as by the Congress.

Contract Audits

The expansion of GAO's review and evaluation of management controls relating to defense contract administration has resulted in the savings of millions of dollars for the taxpayer.

Negotiated contracts for supplies and services for the military agencies are required by law to provide that the Comptroller General's representatives are entitled within specified periods to examine the books and records of the contractors. These contract audits are optional with GAO, but nevertheless they are regarded as a very important part of its work and have required a substantial part of its manpower.

In the absence of effective competition, the charge to the Government for items procured under negotiated contracts is normally determined on the basis of actual or estimated costs to produce, plus a reasonable profit. It is therefore essential to evaluate the cost and profit factors making up the contract price. The basic objective in such audits is to examine the contract performance and administration functions to ascertain whether they were carried out on a sound and economical basis and to obtain corrective actions in cases where operating or procedural defects permit overcharges or waste to occur. The audits performed by the agencies are integral parts of contract administration; GAO audits are not. GAO audits are reviews and evaluations of contract activities carried on by the contractor and the agency; they are highly selective in coverage and frequently more intensive than agency audits. Maximum use is made of the work done by agency auditors as well as reports and data prepared by the contracting officer and contractor, including the work performed by the contractor's internal auditors and the public accountants. The value of these GAO audits had been proved over and over again by findings which have resulted in the recovery of overpayments amounting to many millions of dollars, and the correction of practices and procedures which, if not corrected, would have unnecessarily cost the Government many more millions.

Joint Program for Improving Accounting in the Federal Government

The Budget and Accounting Procedures Act of 1950 gave legislative recognition to the so-called Joint Program for Improving Accounting in the Federal Government which had been started earlier by the Comptroller General, the Secretary of the Treasury, and the Director of the Bureau of the Budget. These three officials as heads of the three central financial agencies had agreed to sponsor a Government-wide cooperative program to modernize and simplify Federal Government accounting to meet the needs of the executive and legislative branches. One of the major objectives of the program was to improve, simplify, and strengthen the Government's system of audit and control. The Ninth Annual Progress Report under this program, recently issued, shows many concrete achievements not only by the central financial agencies but by the many agencies that have wholeheartedly cooperated in the program. This program has of course been tremendously important in the evolution of auditing in the Federal Government.

Internal Auditing in Federal Agencies

Much progress has been made during the past few years in internal auditing in Federal agencies. Only a few years ago such auditing was directed primarily towards verification of the accounts of officials who had custody of money or property with emphasis on the disclosure of errors or irregularities in their accounts. Much of the progress in the development of the broader concepts of internal auditing has occurred within the past decade, and in my opinion is attributable in large measure to the leadership of the Institute of Internal Auditors.

The first internal audit organization in a Federal agency with broad authority to make independent reviews and appraisals of all activities and to report directly to the board of directors was established by the Home Owners Loan Corporation in 1933. I had occasion to observe the operation of this agency prior to its dissolution in 1951, and I am personally aware of the great value of its internal audit organization as an aid in efficient management and in the audit of the agency by GAO. Similar internal audit organizations, also reporting to the board of directors, were created by two other agencies about that time, but the scope of their operations did not extend to all activities. During the period from 1933 to 1941 four additional agencies established internal audit organizations whose functions were quite restricted in comparison with present-day concepts.

Between 1942 and 1946 little progress was made in the development of internal auditing because of the great effort required in the prosecution of the war. After the war the attention focused on the need for new approaches and new techniques as an aid to efficient management. The adoption of the new aids by management has brought rapid progress, particularly since 1949. Contributions to the progress in agencies were many. Among the most significant were:

1. The establishment in 1949 of the Joint Program for Improving Accounting in the Federal Government, which emphasized internal audit and control;

2. The National Security Act Amendments of 1949 creating internal audit organizations in the Department of Defense;

3. Studies by the Hoover Commission, the Cooper Committee, and the General Accounting Office, which have highlighted inadequacies in the management control of agencies; and

4. The Budget and Accounting Procedures Act of 1950 requiring the head of each executive agency to establish and maintain systems of accounting and internal control, including internal audit.

I believe, too, that the Federal Government Accountants Association, in its advocacy of good accounting principles and high standards of auditing, has been tremendously helpful in furthering the professional stature and independence of the internal auditors.

The establishment of a broadly conceived internal auditing program in an agency is an evolutionary process which requires considerable time. To function properly the program must be understood and accepted by management officials who use information supplied by internal audits, and by operating officials whose activities are reviewed and appraised by the internal auditors. Highly selective recruiting and intense training is required to maintain the type of staff capable of making the reviews and appraisals encompassed in modern programs. The evaluation of internal controls and efficiency of operations, as a part of the internal audit function, frequently requires specialized services such as transportation specialists, engineers, appraisers, investigators, and legal experts. Nevertheless many agencies have made very substantial progress in establishing programs conforming with present-day concepts.

There can be no fixed pattern of management controls in the many diverse and complex agencies. It is generally agreed that the precise type of organization required to achieve the objectives of good internal auditing is not especially important so long as the top management is effectively served, appropriate reviews are made, and duplications are avoided.

Most of the development in agency internal auditing, other than the audit of contractor operations, has taken place since 1950. Agency management has become increasingly aware of the inadequacies in systems of operation in providing safeguards at all operating levels for control over costs, expenditures, receipts, revenues, and assets. The need for assurances that authorized programs are being conducted in an effective, efficient, and economical manner has been recognized. Despite the progress that has been made, there is still a great need for more effective internal auditing in the Federal Government.

I will not take the time to recite the progress and developments in all the agencies, but I would like to give you a few examples.

Department of Defense

The Departments of the Army, Navy, and Air Force have a tremendous stake in their internal audit programs, both in terms of the staggering amounts of money involved and in the world-wide scope of their activities. The progress in their internal audit programs has recently been commendable. Let me give you a brief outline of the essential elements of their organizations and objectives.

The National Security Act amendments of 1949 established in each of the three military departments a comptroller responsible for all budgeting, accounting, progress and statistical reporting, and internal audit in their departments, and for related organization structure and managerial procedures. The law provides that each comptroller shall be under the direction and supervision of, and directly responsible to, either the Secretary, the Under Secretary, or an Assistant Secretary of the Department.

The essential point that should be emphasized in discussing the internal audit programs in the military departments is that their current programs conform with the major aspects of present-day concepts—that they are in fact independent appraisal activities as a basis for service to management.

Department of the Army

The Chief, Army Audit Agency, serves as a member of the staff of the Comptroller of the Army, represents him in matters pertaining to audit responsibilities and functions, and develops and executes applicable plans, programs, and policies. Regulations provide that the internal auditor's responsibility is to observe, review, appraise, evaluate, and examine financial and accounting policies, systems, and procedures, and performance thereunder, relating to all resources and operations for the purpose of reporting findings and recommendations for corrective action to management.

The Army Audit Agency began its operations with a total strength of about 900, including about 400 in the professional category. Today it has 9 regional offices, including overseas offices in Germany, Japan and Alaska. There were 39 operating branch and area offices and 52 residencies at military installations and contractors' plants. These offices are located in most of the 48 states, Hawaii, Alaska, Puerto Rico and in such widely scattered foreign areas as the Canal Zone, France, Morocco, Korea, Libya, and Okinawa. The total strength is about 2,400, including about 1,500 auditors, all in the professional category. Three hundred and thirty-five of these auditors hold CPA certificates.

Under its Auditor Intern Program, beginning in 1954, 675 selected graduates of colleges and universities have been added to the agency's staff.

In 1953, installation-wide audits and related reporting to installation commanders and higher levels of command were substituted for the account-type audits. The installation-wide audit includes concurrent examination of the financial effectiveness of all of the installation's operations as an entity, including programming, budgeting, funding, accounting, purchasing, property control and disposal, and the other functions of the installation.

A vertical-type audit introduced in 1956 enables the auditors to render a fuller audit service by the concurrent examination of selected transactions in all Department of the Army levels concerned with the determination of requirements, budgeting, funding, procurement or manufacture, shipment, receipt, storage, issue, and end use.

In 1957 a lateral-type audit was added as a companion to the vertical-type audit. The lateral-type audit is a concurrent Army-wide examination of the financial aspects of a common operation or function performed throughout the Army.

Audit service for the Army has been significantly extended and improved during the past few years. Voucher verifications under cost-type contracts have evolved into broader examinations of contractors' records and controls; and audits of major fixed-price redeterminable contracts have changed from a one-time approach at the redetermination point to a more effective examination throughout the life of the contract. Through the extended use of professional auditing procedures the audits were broadened to include physical observations and checks of operations, labor, inventories, and use of facilities. Audit service to procurement officials was expanded to provide accounting counsel relating to contract financing, contractual provisions which operated to the detriment of the Government's interest, pre-award surveys, initial and repricing negotiations and other areas. The expansion of audit service to individual contracting officers branched out to a wider service to the entire Army Establishment through an evaluation of certain aspects of procurement actions. Basic contracts, supplemental agreements, financing, payments and other contract administration actions were reviewed in the light of the auditor's knowledge of the contractors' cost and operating experience, and disclosures were made where the Government's interest appeared to be adversely affected.

Department of the Navy

Navy internal auditing is under the management and technical control of the Assistant Secretary of the Navy for Financial Management who is also the Comptroller of the Navy. The Comptroller delegated responsibility for internal auditing operations to an Assistant Comptroller who is assisted by the Director of the Internal Audit Division. The principal objective of internal auditing is to provide a protective and constructive service to all levels of management by means of independent appraisals and constructive suggestions and recommendations. The Navy recognizes that internal auditing deals not only with accounting and financial matters but may properly deal with matters of an operating nature that have financial significance.

The Navy audit organization includes 850 professional accountants of whom about 10 per cent are CPA's. Continuous internal audits have been established at 12 bureaus and offices and 13 major field activities to provide management with more timely and effective audit service. Future plans provide for the establishment of approximately 60 continuous audit assignments.

Internal audit coverage has been broadened significantly by the promulgation of specialized audit programs for the areas of procurement, supply management, inventory management, and Government property in the possession of contractors.

In the field of contract auditing, increased reliance is being placed on the internal controls established by private contractors. Audit emphasis is concentrated on the contractors' procedures and practices as a whole rather than on the cost items as charged to individual contracts.

Department of the Air Force

In the Air Force the Auditor General is the internal auditor. He is on the staff of the Comptroller of the Department. The Auditor General's functions include the audit of both internal activities and contractual activities. He is required among other things to audit, review, appraise, and furnish reports to provide assistance to Air Force management at all echelons in achieving efficient administration of accounting and financial matters related to the need, acquisition, custody, use and conservation of Air Force funds, property, and other resources; initiate and perform audits, reviews or surveys of the internal business and financial functions, systems and accounts within or under the jurisdiction of the Air Force including procurement activities.

The Auditor General's organization includes four district offices in the United States, foreign district offices in Germany and Japan, and about 300 residencies at Air Force bases and in contractors' plants. His staff consists of more than 1,900 professional accountants including about 150 CPA's. Nearly half of this staff is engaged in the audit of procurement contracts.

There are three areas that I would like to mention briefly in which the Air Force has done notable work. These are in the application of statistical sampling techniques to auditing, the development of techniques for audit of electronic data processing systems, and the development of what the Air Force terms "directed audit programs."

Many accountants and auditors in industry and government have long recognized the potential benefits of applying statistical sampling methods to increase the effectiveness of the auditor's test checking. In 1953 the Air

Force Auditor General initiated a research program in this area, the results of which have gained widespread recognition throughout the accounting profession. Feasibility studies and tests were conducted in 1954 and 1955; and in 1956 a few field audit tests using statistical sampling techniques were performed under actual working conditions. In fiscal years 1957 and 1958 many audits using these techniques were performed, covering areas such as military pay, supply operations, motor vehicle inventories, costs and expenses of defense contractors, and several procurement programs. These studies and field audits proved the practicability of the statistical sampling methods. This agency is now integrating statistical sampling techniques into its internal and contract audit programs to the fullest practical extent.

The use of electronic equipment for data processing is a relatively new science, and there is a general lack of experience for the audit of such systems. Over the past three years the Auditor General has been studying these problems and developing audit guidelines and programs for electronic data processing systems. Initial study has shown that the auditors engaged in this work will need specialized training. An extensive training program for field audit personnel, begun early last year, is substantially completed.

The term "directed audit programs" refers to uniform, detailed audit programs, printed in working paper format, covering those phases of an account or activity which are of primary interest to top Air Force management. These programs are prepared by the Auditor General staff and are distributed for simultaneous world-wide application by Air Force auditors. The Air Force audit organization differs somewhat from the Army and Navy in that they work with a resident auditor concept as opposed to mobile or traveling auditors. The Air Force thus has the capability for concurrent world-wide execution of a standard audit program. It gives the Air Force a summarization capability with respect to audit reporting, which is often useful in presenting a command-wide or Air Force-wide picture for management purposes at the top echelons. I should emphasize that only selected phases of activities are to be covered by directed audit programs. The Air Force recognizes that its auditors must still use initiative, judgment, and professional ability to identify local needs which may not be covered by the directed programs and to extend their audit coverage accordingly.

Internal Revenue Service

The Internal Revenue Service is an outstanding example of an agency that has recognized the extreme importance of modern internal auditing concepts in its operations. The internal auditing division of the Service is responsible directly to an Assistant Commissioner. It develops, coordinates, and controls the policies and programs for internal audits which are designed to assure that responsibilities at all organizational levels are properly and effectively discharged, and to provide a basis for constructive action by management. The Commissioner of Internal Revenue, who has spent the greater part of his life in the auditing profession, has a real appreciation of the value of the internal audit function and has taken a keen interest in the establishment of procedures to assure prompt and effective action to correct deficiencies disclosed by internal audits.

Department of Agriculture

In 1954 the Department of Agriculture, one of the older departments, issued a "Statement of Internal Audit" to the heads of the Department's agencies. This statement emphasized the Department's position that internal auditing is a staff function completely independent of line operations, thereby permitting the auditors to provide management with impartial views concerning their review and appraisal of agency policies, plans, and procedures. The primary objective of internal auditing was defined as assistance to management in achieving effective, efficient, and economical administration of the operations of the agency. In June 1956 the Secretary created in his office the position of staff assistant for program appraisal, thus giving added emphasis to the internal audit functions.

Several agencies in the Department have good internal auditing; for example, the internal audit division of Commodity Stabilization Service. This agency includes the Commodity Credit Corporation, which is a Government corporation, whose transactions in loans and commodities amount to billions of dollars annually. The over-all objectives of its internal audits provide for ascertaining, reviewing, and appraising internal controls, financial data, policies, plans, and performance. All activities and major functions are audited. Audit reports are submitted promptly to appropriate management levels, and the top management is furnished with a monthly summary of audit findings. Recommendations are followed up to determine whether appropriate action has been taken.

Relationship of Agencies' Internal Auditing to GAO Audit Responsibilities

Officials of GAO are sometimes asked whether their audits duplicate in some respects those of the agencies' internal auditors. The answer to that question is based upon the difference between the final objectives and responsibilities of GAO and the agencies. GAO recognizes and has a vital interest in the accounting and internal control procedures of the agencies because they are the basic points for effective control of the Government's financial operations. As I mentioned earlier, GAO is required to give due regard to the effectiveness of agency accounting, internal controls, and related administrative practices. Its position in that respect is somewhat similar to that of public accountants. It has the responsibility to review agency management controls, including internal audits. It may accept or reject the work of the internal audit group, but in any event it must do sufficient detailed work to evaluate the work of internal auditors. In practice this is an appraisal, not a duplication. In 1957 the Comptroller General issued a statement of basic principles and concepts of internal auditing to the heads of all Federal Government departments and agencies. This statement enunciates principles and concepts that are generally in consonance with those advocated by the Institute of Internal Auditors, and it contains an explanation of the relationship of internal auditing to GAO's audit responsibilities.

As an official of GAO during the past 12 years I have had an opportunity to observe the management of Federal agencies. Internal auditing in many cases has progressed from a narrow concept of auditing only financial transactions and records to the present-day concept of a broad service to management. This evolution is still going at high speed. I believe that the professional stature of the internal auditor will become more firmly established as progress continues.

Conclusion

Many Federal agencies have made excellent progress in the application of modern principles and practices of auditing. In some cases, however, progress has been distressingly slow, and results have not been satisfactory. Nevertheless, the evidence indicates that, in general, greater progress has been made during the last decade than during any other period in the history of the Federal Government.

Efficiency and economy in Government operations cannot be achieved without sound financial administration including the use of the type of accounting and auditing that is essential for modern management. The continued improvement and maintenance of sound financial administration in all Federal agencies is indeed an objective that deserves the full support of all professional accountants, their state and national accounting associations, and the educational institutions throughout the Nation.

Opportunities for Accountants and Auditors in the Federal Government

The Federal Government needs more professional accountants and auditors. The need is especially urgent for promising college-trained accountants who can keep pace with the evolutionary developments now in process in Federal Government accounting and auditing. Never before in the history of the Government has the need been more urgent or the challenge greater than it is at this time. Attractive positions are being offered in a great variety of interesting accounting and auditing work in many Federal agencies located in the principal cities of the United States and in foreign countries.

Many of the agencies in which these positions are being offered have well-developed internal audit organizations that make periodic full-scale internal audits of their bureaus, divisions, and field offices. Some of them send their auditors into the plants of industrial companies to audit contracts. Special investigations of many kinds are made by some agencies, such as the Federal Bureau of Investigation, GAO, the Post Office Department, the Internal Revenue Service, and the internal audit staffs of several other agencies.

The technical and professional challenges in many agencies, both large and small, are such as to require high standards of competence and adequate training. The Federal career service offers unparalleled opportunities to those who are seeking careers in high-level accounting and management positions, as well as to those who are interested in pioneering in developments in new management control techniques, such as electronic data processing, and scientific statistical sampling.

Most of the larger agencies and some of the smaller ones conduct organized training programs. More and more emphasis is being placed on up-grading staff competency and on career development. According to a recent estimate the agencies have about 2,500 CPA's on their staffs, and the number is steadily increasing. Many employees take advantage of classroom and correspondence training as a means of preparing for CPA examinations. In GAO alone such training has been helpful assistance to about 100 employees in obtaining their CPA certificates after they joined the staff. Experience in GAO and on the larger internal and field audit staffs of other agencies is accepted, partially or wholly, by many of the states in considering experience qualifications for CPA candidates.

Federal Government Accountants Association

I would like to mention the Federal Government Accountants Association which is making a valuable contribution to the cause of good government and of which I have the honor of being the current president. This Association was incorporated in 1951 as a nonprofit organization in recognition of the need for a professional society of Federal accountants and auditors. Its membership, comprised primarily of responsible accounting, auditing, and budget officers of the Federal agencies, is now about 3,000 organized in 28 chapters from coast to coast, with one chapter in Japan, one in Frankfurt, Germany, and one in the Canal Zone. Its basic aims are the continued improvement of Federal financial control procedures, more efficient financial management, and improvement of the general caliber of Federal Government accounting and financial management personnel. These worthy aims are being furthered by its varied activities, such as an annual symposium, technical meetings, seminars, round-table discussions, cooperation with other professional societies, and publication of a technical journal. The technical journal, called *The Federal Accountant*, is published in March, June, September, and December by the Association in cooperation with the Graduate School of Business and Public Administration, Cornell University, Ithaca, New York.

The Association also published in 1956 a pamphlet entitled "Opportunities for Accountants in the Federal Government" which was compiled in cooperation with the United States Civil Service Commission and distributed to libraries and educational institutions throughout the country. Federal agencies seeking college graduates assisted in the preparation of the pamphlet by supplying extensive information on their needs for accountants and on available opportunities.

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